United States General Accounting Office

GAO

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

September 1996

FEDERAL RESERVE BANKS

Inaccurate Reporting of Currency at the Los Angeles Branch

GAO/AIMD-96-146

GAO

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

Accounting and Information Management Division

B-274060

September 30, 1996

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

Dear Mr. Gonzalez:

This letter responds to your request that we review reports on currency activities prepared for the Federal Reserve Board of Governors by the Los Angeles Federal Reserve Bank, a branch bank of the San Francisco District Bank. You expressed concern that management at the L.A. Bank had directed staff to report inaccurate numbers in such reports to ensure that they balanced with other reports generated from the Bank's accounting data base. You asked us to (1) determine the nature of problems that may have occurred in reporting currency activity for Federal Reserve note receipts, payments, and amount on hand and (2) review and comment on corrective actions planned or taken by the Federal Reserve to resolve those problems. We focused on the reports for the months of October through December 1995 because those had been identified by your staff and the Federal Reserve as months in which the reports were prepared incorrectly.

Background

Each of the 37 banks (12 district and 25 branches) in the Federal Reserve System prepares monthly currency activity reports, known as the FR 160 reports. The monthly currency activity reports are transmitted to the Board of Governors to document movement of currency through the banks and to summarize the total currency on hand in the respective banks' vaults. These reports and the underlying systems that they are generated from constitute the Federal Reserve's only detailed records of currency transactions throughout the Federal Reserve System and the respective ending balances by denomination. Thus, information on monthly currency movement in and out of Federal Reserve Banks provided to Federal Reserve management (including the Board of Governors), the Congress, and other external users of this information would be based on data from the monthly currency activity reports.

According to the Board of Governors, the uses of this report are four-fold:

- "to provide an inventory of collateralized Federal Reserve notes,

- to monitor payout patterns,
- to assess the currency stock needs of the various districts, and
- to generate a variety of ongoing and ad hoc reports for the Board, Reserve Banks, other government entities, and the public."[1]

In addition, each Federal Reserve Bank (FRB) prepares a daily balance sheet (the FR 34 report) that shows all of the assets, liabilities, and equity for the bank. In particular, the daily balance sheet shows the balance of currency in the respective bank's vault at the end of each day. At the end of each month, to ensure agreement, the reported vault cash balance in the last daily balance sheet of the month is compared to the ending balance reported in the month-end currency activity reports.

The L.A. Bank manages over $80 billion a year in currency, second only to the New York FRB. The L.A. Bank uses an electronic cash inventory system to manage this currency, but not every FRB uses the same system or even an electronic one. A Board of Governors official stated that the Philadelphia and Atlanta Federal Reserve District Banks, including their respective branch banks, also use the same cash inventory system as the San Francisco District Bank and its branches, including the L.A. Bank. The official stated that the New York and Dallas District Banks have other electronic information systems to account for their detailed cash transactions. Board officials also said that systems in the Kansas City, Minneapolis, Chicago, Cleveland, and Richmond District Banks are housed in a personal computer-based local area network. The two remaining district banks, Boston and St. Louis, manually account for these transactions and inventory of cash on hand.

Objectives, Scope, and Methodology

The objectives of our review at the L.A. Bank were to

- determine the nature of the problems that may have occurred in reporting currency activity for Federal Reserve note receipts, payments, and amount on hand and
- review and comment on corrective actions planned or taken by the Federal Reserve to resolve those problems.

We conducted our review in three parts. First, we examined the use and preparation of the monthly currency activity report. To accomplish this, we (1) reviewed the L.A. Branch and San Francisco District Bank's

[1]Board of Governors of the Federal Reserve System, Division of Information Resources Management, Technical Memorandum No. 91, "Processing Procedures for the CASH Series," November 9, 1994.

policies and procedures for preparing this report, (2) met with officials at the Board of Governors and examined official policies to determine the uses of the report, and (3) interviewed analysts and managers at the L.A. Bank to determine how staff were told to prepare the currency activity report and what controls were in place to ensure that the numbers reported were accurate.

In the second part of our review—determining the nature of the reporting problems—we attempted to perform a comprehensive assessment of the L.A. Bank's accounting practices and internal controls over currency. However, our efforts were restricted by the lack of readily available historical data maintained by the L.A. Bank. For example, L.A. Bank officials stated that they could not readily provide the detailed general ledger transactions that had been recorded for the currency in their account. L.A. Bank officials stated that the information was not stored in a format that would allow for detailed analysis of transactions and that conversion to such a format would take a significant amount of time.

For 6 judgmentally selected days in the October through December 1995 period, we attempted to perform limited reviews of the L.A. Bank's reconciliations. These reconciliations compare the Bank's general ledger balances (which are used to prepare the daily balance sheet) to its cash inventory system (which contains the physical inventory file). However, our efforts to perform limited reviews of these 6 days were hindered because the L.A. Bank could not locate some of the requested data. For instance, the L.A. Bank could not locate the report containing the ending balance of the amount of currency in the vault as reported in its cash inventory system for one of the days selected in our review. To enhance our understanding of the Bank's reconciliation process, we also did a walkthrough of 1-day's reconciliation efforts with bank employees in June 1996.

In addition, for October through December 1995, we examined transactions in general ledger accounts that were used to account for reconciling differences found that were either written off or were temporarily held aside for further research and disposition. We gathered information on Bank procedures for resolving out-of-balance situations and differences between amounts reported and actually received from banks. Because the L.A. Bank could not provide the general ledger transaction history for its cash accounts, we could not determine whether the accounts and activity provided to us by the Bank represented the universe of cash activity. Thus, we only tested the transactions provided to us. Further, we did not perform a review of (1) the L.A. Bank's computer security controls for preventing unauthorized access to its general ledger and cash inventory system or (2) its physical access controls for ensuring that the money it manages is protected from theft and misappropriation.

In the third part of our review, we interviewed Bank officials and reviewed the new procedures for preparing the currency activity reports and the revised reports to determine if their efforts to comply with their policy for preparing these reports were effective in resolving the problems identified.

We conducted our work at the Federal Reserve Bank in San Francisco and its branch bank in Los Angeles between June 1996 and August 1996 in accordance with generally accepted government auditing standards.

Results in Brief

We found that the October, November, and December 1995 monthly currency activity reports of the L.A. Bank were prepared and reported incorrectly. We confirmed that the reported receipts from currency deposited in the L.A. Bank by depository institutions (receipts from circulation) were not taken from the L.A. Bank's cash inventory records (in other words, independently determined) but rather "forced" to ensure that the currency activity report agreed with the daily balance sheet for the last day of the month. For example, the report filed for December 1995 had a forced amount of $3.771 billion for receipts from circulation to ensure that the ending balance for cash on hand would equal $6.7 billion as reported in the daily balance sheet at the end of December. In contrast, when the L.A. Bank recently attempted to independently determine receipts from circulation for December 1995 (as it should have done at the time it prepared the monthly currency activity report), it calculated this amount at $3.882 billion, a difference of $111 million from the forced amount on its original monthly currency report for December. As discussed further on page 10, the $111 million is a net figure and represents a number of errors that were initially obscured because of the L.A. Bank's practice of forcing the receipts from circulation in preparing the monthly currency activity report.

These reports were prepared incorrectly at the direction of the L.A. Bank's management. L.A. Bank officials stated that the practice of forcing the reports to agree had been in place for some time. This practice, however, is not consistent with guidance on preparing the monthly currency activity report issued by the Board of Governors, which, in essence, calls for the amounts to be independently determined and reconciled. This guidance calls for comparing the calculated ending balance (the beginning balance plus receipts less expenditures equals the calculated ending balance) on the monthly currency activity report to the amount in the vault on the last day of the month, as reported in the daily balance sheet, to ensure that they agree. These amounts should agree, and, if they do not, differences that are greater than the allowed $3 million tolerance for errors, or for amounts less than the tolerance if requested, should be researched and corrected or explained. The L.A. Bank's practice of forcing certain amounts made ending cash balances of the two reports agree when they actually did not.

The L.A. Bank has made efforts to revise the currency activity reports that were filed incorrectly, back to October 1995. However, revised reports were not transmitted to the Board of Governors. According to L.A. Bank officials, the Board requested that they receive the revised reports all at once and only for those months that had substantive revisions. Officials stated that the revised currency activity reports were reconciled to within the net, plus or minus, $3 million tolerance allowed for in the Board of Governors' policy. However, the ending balance for the revised currency activity report and the reported vault cash balance in the daily balance sheet still do not equal. Thus, one or both of the reports are incorrect.

We found that the problems in currency reporting are linked to the limitations in the design of the underlying cash inventory system. A key limitation is the inability to link the detailed transactions posted in the stand-alone inventory transaction files to the postings in the inventory file, which shows cash in the vault by denomination. Thus, these problems may also have occurred in the San Francisco District Bank and its other branches and the other two FRB districts and their related branches that use this system.

The L.A. Bank's inability to precisely summarize currency activity from its cash inventory records raises serious questions about the integrity of its accounting and internal controls. A comprehensive review of these controls and accounting is needed. In addition, the Federal Reserve Board needs to take appropriate steps to assure itself that such problems do not exist in the accounting and internal controls at other FRBs.

Currency Activity Reports Were Prepared and Reported Incorrectly

The monthly currency activity reports are required to be prepared in accordance with guidance in the Board of Governors' Technical Memorandum No. 91 "Processing Procedures for the CASH Series." This guidance states that the calculated ending balance in the monthly currency activity report should be compared to the reported end-of-the-month balance for cash in the vault on the Bank's daily balance sheet and that corrective actions should be taken to resolve any substantial differences. This guidance also underscores that, if requested, explanations must be provided for any differences (other than rounding) between the month-end balance sheet amount and the ending balance on the currency activity report for cash in the vault. This guidance does not state how the amounts reported in the currency activity report are to be determined. However, to complete the report in a meaningful way, each reported amount, except the ending balance for cash in the vault, which is calculated as noted above, would need to be independently determined.

Table 1 shows excerpts from the L.A. Bank's spreadsheet used to prepare the monthly currency activity report for December 1995.[2] Table 2 provides excerpts from the revised spreadsheet on currency activity for December 1995—the revision was not transmitted to the Board of Governors. As noted on page 9, inaccuracies in amounts reported on the monthly currency activity reports for the fourth quarter of 1995 were discovered during a compliance review. As a result of this review, the revised spreadsheet was developed by the L.A. Bank.

[2]Tables 1 and 2 are excerpts from spreadsheets developed by the L.A. Bank and contain the same information as the currency activity reports. The actual report could not be duplicated here.

Table 1: Excerpt From December 1995 Currency Activity Spreadsheet as Filed

Dollars in thousands

	$1	$2	$5	$10	$20	$50	$100	Total
On hand at the beginning of the month:	96,017	4,411	143,129	181,314	3,912,998	1,187,041	2,719,633	8,244,543
Rec from circulation	79,305	349	82,980	95,692	1,751,078	321,364	1,440,102	3,770,870
Rec from BEP	0	0	0	0	0	0	0	0
Rec from other FR offices	35,400	0	0	0	0	0	0	35,400
Total currency available	210,722	4,760	226,109	277,006	5,664,076	1,508,405	4,159,735	12,050,813
Paid into circulation during month:	91,114	974	94,215	86,174	1,808,230	385,435	978,350	3,444,492
Forwarded for redemption	36,290	311	30,549	28,968	311,170	80,392	1,383,707	1,871,386
Returned to BEP	0	0	0	0	0	0	0	0
Shipped to other FR offices	0	0	0	0	0	0	0	0
Total currency expended	127,404	1,285	124,763	115,142	2,119,400	465,827	2,362,057	5,315,878
On hand at end of the month:								
FR 34 total	83,318	3,475	101,346	161,864	3,544,676	1,042,578	1,797,678	6,734,935
Total (calculated)	**83,318**	**3,475**	**101,346**	**161,864**	**3,544,676**	**1,042,578**	**1,797,678**	**6,734,935**
Difference	0	0	0	0	0	0	0	0

Note: This excerpt only includes most summary items for the L.A. Bank and excludes items containing zeros.

Legend: Rec stands for received; FR stands for Federal Reserve; and BEP stands for Bureau of Engraving and Printing.

Table 2: Excerpt From December 1995 Currency Activity Spreadsheet as Revised

Dollars in thousands

	$1	$2	$5	$10	$20	$50	$100	Total
On hand at the beginning of month:	96,017	4,411	143,129	181,314	3,912,998	1,187,041	2,719,633	8,244,543
Rec from circulation	**76,597**	**353**	**83,034**	**95,942**	**1,769,661**	**417,066**	**1,439,923**[a]	**3,882,576**
Rec from BEP	**28,160**[b]	0	0	0	0	0	0	28,160
Rec from other FR offices	**10,000**[b]	0	0	0	0	0	0	10,000
Total currency available	**210,774**	**4,764**	**226,163**	**277,256**	**5,682,659**	**1,604,107**	**4,159,556**	**12,165,279**
Paid into circulation during month:	91,114	974	94,215	86,174	**1,826,212**[c]	385,435	978,350	3,462,474
Forwarded for redemption	36,290	311	30,549	28,968	311,170	80,392	1,383,707	1,871,386
Returned to BEP	0	0	0	0	0	0	0	0
Shipped to other FR offices	0	0	0	0	0	**96,000**[d]	0	96,000
Total currency expended	127,404	1,285	**124,764**	115,142	**2,137,382**	**561,827**	2,362,057	**5,429,860**
On hand at end of the month:								
FR 34 total	83,318	3,475	101,346	161,864	3,544,676	1,042,578	1,797,678	**6,734,935**
Total (calculated)	**83,370**	**3,479**	**101,399**	**162,114**	**3,545,277**	**1,042,280**	**1,797,499**	**6,735,419**
Difference	**-52**	**-4**	**-53**	**-250**	**-601**	**298**	**179**	**-484**

Note: This excerpt only includes summary items for the L.A. Bank and excludes most items containing zeros.

[a]New calculated amounts for receipts from circulation, instead of forced amounts on original report.

[b]$28,160,000 was misclassified as received from another Federal Reserve office instead of from the Bureau of Engraving and Printing (BEP). $2,240,000 in coins were deleted from the currency report but had been included in the original report. $5,000,000 received from the Federal Reserve Bank of New York was added, which was missing from the original report.

$35,400,000	Original amount shown as received from other Federal Reserve offices
- 28,160,000	Received from BEP
- 2,240,000	Coins which were originally included on the currency report
+ 5,000,000	Received from Federal Reserve Bank of New York, missing from original report
$10,000,000	Amount shown on revised report as received from other Federal Reserve offices

[c]This figure increased by $17,982,000 paid to circulation that were manually recorded transactions, which were missing from the original report.

[d]$96,000,000 shipped to the Federal Reserve Branch Bank in Seattle, which was missing from the original report.

Legend: Rec stands for received; FR stands for Federal Reserve; and BEP stands for Bureau of Engraving and Printing.

As can be seen from comparing the L.A. Bank's spreadsheet for the filed currency activity report for December 1995 (table 1) to the revised spreadsheet (table 2), the forced amounts for receipts from circulation changed after the L.A. Bank conducted a compliance review and identified inaccuracies. The practice of forcing the receipts from circulation amount in the monthly currency activity report, as opposed to independently determining the amount, is not consistent with the Board of Governors' guidance for validating the accuracy of the currency activity report. Federal Reserve officials stated that it is a common practice for FRBs to adjust the receipts from circulation line to balance the monthly currency activity report ending total to the balance sheet if it is within the plus or minus $3 million tolerance established by the Board of Governors. However, at least for October through December 1995, the L.A. Bank did not determine that the forced amount was within the $3 million tolerance. Forcing receipts from circulation allowed errors to occur that were neither reported nor explained. In fact, this practice obscures any other differences that might exist between the two reports.

Had these amounts been determined using appropriate procedures, the ending balance of cash on hand, which is intended to be the calculated amount in the monthly currency activity report, would have been at variance with the daily balance sheet. Consequently, the differences would have been researched and corrected or explained.

L.A. Bank internal correspondence confirmed that the Bank's problems preparing and reporting the monthly currency activity report were initially found by an analyst who was responsible for preparing the report. The analyst stated that queries made from the cash inventory system to identify receipts from circulation for the report showed substantial differences from the amount that was forced in the report. Bank management officials in the L.A. Bank and its San Francisco district bank confirmed that analysts were instructed to force the amount in the report for receipts from circulation and that this practice had been in place for several years.

L.A. Bank officials stated that the discrepancies reported in the monthly currency activity reports for the fourth quarter of 1995 were brought to their attention as a result of a planned compliance review. They stated that through the review, performed under the direction of Bank management and completed in January 1996, the compliance analyst discovered and communicated to Bank management that incorrect amounts appeared to be reported on the monthly currency activity reports for the fourth quarter of 1995.

As part of this review, the compliance analyst found that the preparer of the reports had identified discrepancies between the preparer's efforts to independently calculate receipts from circulation and the forced amount. Using data obtained through queries to the cash inventory system combined with manual records, the compliance analyst initially recalculated the receipts from circulation. The analyst determined that receipts from circulation in October should have been $5.8 million more than what was originally reported; in November, $61.8 million less; and, in December, $111 million more. In addition to the errors identified for receipts from circulation, we confirmed that other errors had been obscured as a result of the L.A. Bank's practice of forcing the receipts from circulation.

- The December 1995 currency activity report contained errors in the aggregate of about $121 million, which resulted in the above noted $111 million understatement in reported receipts from circulation. Specifically, it failed to include $96 million shipped to the branch bank in Seattle because a clerk did not include the transaction on the manual log used to record shipments of currency between FRBs. Another $5 million received from the New York FRB was excluded from the report because it too was not in the manual log. The report preparer also did not include most of the manual transactions for the month, which was about $18 million paid into circulation. Finally, the report preparer incorrectly included about $2 million in coin receipts on the currency report.
- The October 1995 currency activity report had a $2.7 million error. While preparing the report, the report preparer mistakenly entered $300,000 for a $3,000,000 amount paid into circulation. This error resulted in understating the amount of currency paid into circulation by $2.7 million, which caused the forced amount received from circulation to be understated.

We verified that the L.A. Bank's subsequent efforts to independently determine receipts from circulation for October through December 1995 showed that the initially filed reports were incorrect. These efforts were known by L.A. Bank officials to be incomplete because they did not account for differences that occur due to the time lag between receipt and processing of currency. Thus, other errors could have existed that were not detected. Due to our time constraints and the resulting limited nature of our work, we did not attempt to determine what the correct amount should have been or if other errors were made.

L.A. Bank Has Made Some Progress but Still Forces Reports to Balance

Officials at the L.A. Bank assumed that the data in their general ledger as reported on the daily balance sheet were correct and have therefore focused their efforts on correcting and improving the preparation of the monthly currency activity reports. Officials said that their objectives were to (1) eliminate errors, (2) independently determine the receipts from circulation amount in the currency activity report, and (3) ensure that the currency activity reports' ending balances equal the daily balance sheets within the Board of Governors' policy of plus or minus $3 million. L.A. Bank officials stated that they were confident that implementation of their new procedures, as applied in April 1996, would correct the reporting inaccuracies associated with the receipts from circulation line.

After the compliance review was completed, branch analysts reviewed several previously issued currency activity reports to identify and research the causes of errors. In an effort to prevent data entry errors and help ensure that all data is included in the receipts from circulation, Bank officials said that they now require supervisory review before the report is transmitted to the Board of Governors. In this process, an L.A. Bank officer and supervisor are to review the reports and the supporting documentation for each line item.

L.A. Bank officials stated that important actions were taken to revise a series of queries to the cash inventory system in an attempt to independently determine receipts from circulation. Officials said that the queries of the cash inventory system are now used to collect some of the data that were previously collected from manual logs. For amounts not included in the cash inventory system, the Bank continues to collect the data manually. In addition, the officials stated that queries are used to determine differences that can occur in the Bank's cash inventory system and general ledger due to the time lag between receipt and processing of money—an important problem the Bank faced in balancing the currency activity report with the daily balance sheet that we discuss in more detail on page 15.

The new procedures were used to prepare the April through June 1996 reports. The December 1995 through March 1996 currency activity reports were revised using the new procedures but have not yet been submitted to the Board of Governors. According to L.A. Bank officials, the Board requested that they receive the revised reports all at once and only for those months that had substantive revisions. Bank officials stated that they plan to correct other months that were incorrectly filed back to October 1995 in both the revised reports and the reports that were prepared using the new procedures. Even so, the Bank has not precisely summarized currency activity. The L.A. Bank should have done so using the new procedures because these procedures state that receipts from circulation should be independently determined using the same sources that post to the general ledger. To make the monthly currency activity report balance with the daily balance sheet, the amount reported as received from circulation was reduced by $307,600 for January; reduced by $190,600 for February; reduced by $189,000 for March; increased by $2,074,000 for April; increased by $29,000 for May; and increased by $24,000 for June. Each of these adjustments were within the Bank's $3 million tolerance for error for months in 1996.[3]

According to a Board official, the $3 million tolerance was established to facilitate timely reporting to the Board of Governors. Despite the fact that these numbers fall within the Board of Governors' policy that allows for a $3 million tolerance for error, the unexplained differences raise the concern that either the queries to summarize inventory activity are still inaccurate or that there are more fundamental problems that need to be addressed. Without the historical general ledger data, we were unable to do the work necessary to develop an opinion on that matter.

Two other changes have been introduced to improve preparation of currency activity reports. First, officials said that they plan to prepare the currency activity reports on a daily and weekly basis so that if errors are identified, it will be easier to research the cause of the problem. In addition, officials reported that they plan to create a new position—reports clerk—to specialize in the preparation of this and other reports.

Balance Sheet and Currency Activity Report Ending Balances Share the Same Sources and Should Agree

The L.A. Bank prepares the monthly currency activity report primarily using its Cash Automation System files (its cash inventory system, which provides a perpetual inventory file that tracks currency by denomination); Integrated Accounting System (its general ledger); and manual records (for transactions recorded in the general ledger that are not recorded in the cash inventory system). These cash inventory and general ledger systems interface in that, for the most part, detailed transactions are entered into the cash inventory system and posted to the general ledger. However, they are different because the general ledger posts at a detailed level but not by denomination, while the cash inventory system posts to multiple files, at a summary level, and by denomination. In addition, some

[3]When the December 1995 report was revised, it was out of balance by $484,000.

transactions handled by the Bank's cashier—primarily consisting of currency transactions with government entities and L.A. Bank staff—are recorded directly into the general ledger and are not recorded in the cash inventory system.

Generally, the cash inventory system consists of multiple stand-alone files that record each type of currency transaction. For example, one stand-alone file for receipts from circulation is called the detailed deposit file and another stand-alone file to record monies disbursed or "paid out" from the vault to depository institutions is called the detailed order file. In addition to these transaction files, the cash inventory system has a stand-alone perpetual inventory file that is supposed to track the balance of currency and coin in the Bank (all money in the Bank is considered for accounting purposes to be in the vault, even though it may not be physically in the main vault) by denomination, in total, and by location within the Bank.

This inventory file also tracks increases and decreases to the vault inventory but does not link the increases or decreases to the specific type of transaction that prompted the change. Another key file in the cash inventory system is the cash file that accumulates the detailed transactions processed by the cash inventory system for posting to the general ledger. The accumulated transactions are uploaded periodically—hourly or daily—at a detailed level into the general ledger, without distinction by denomination.

The L.A. Bank's inability to precisely summarize the detailed activity in its cash inventory and manual records, as demonstrated by the problems found in preparing its currency activity reports, raises important concerns. First, data for the currency activity report and the daily balance sheet basically come from the same sources—the detailed cash inventory records of cash transactions and manual records. An inability to balance the two reports without forcing the number for receipts from circulation indicates that there could be problems with the source data in the cash inventory system or the summary information reported in the L.A. Bank's daily balance sheet.

Accounting Practices and Internal Controls Over Currency

We attempted to perform a comprehensive review of the L.A. Bank's internal controls and accounting practices over the money flowing through the Bank. Our efforts to perform a comprehensive review were substantially limited by the L.A. Bank's inability to provide the information needed for the review in a timely manner. While such data availability constraints prevented an in-depth assessment, we performed limited procedures and found other potential data integrity and procedural problems in the L.A. Bank's efforts to account for and report the money it manages. Based on (1) the size and nature of the L.A. Bank's operations, which involve managing large sums of money, (2) its inability to accurately summarize its financial records, and (3) the problems found from our performance of limited procedures, we believe a detailed internal control review is needed in the L.A. Bank to provide independent assurance that these assets are properly accounted for and controlled.

To perform a comprehensive review of the L.A. Bank's internal controls and accounting for the money processed through the Bank would have required us to perform extensive audit procedures. To do this, we requested that the Bank provide us with (1) the reconciliations it prepares for its currency accounts and (2) a general ledger history of all of the activity in its general ledger cash accounts for October through December 1995.

The L.A. Bank did not provide significant portions of the requested information, and some of the requested documents were still not available at the time we completed our review. Bank officials stated that it would take them over 3 weeks to provide us their general ledger history of cash transactions. According to these officials, all of the Bank's historical accounting transaction data are stored in such a way that makes retrieving and converting the information into a data format very difficult. Because this information was not readily available, we had to limit our audit approach.

To perform our review without a general ledger history of cash transactions is comparable to trying to verify someone's personal bank account reconciliation without having their checkbook. This information was needed, in part, because of our concern over the L.A. Bank's inability to precisely summarize the information in its cash inventory system and the limitations in the system's design that preclude readily linking the detailed transactions in its cash inventory system to the summary postings made to its perpetual inventory file. L.A. Bank officials stated that the Bank's cash inventory system, by design, does not identify or retain items that are grouped together and posted in summary from the cash inventory system to the inventory file.

This design limitation presents two fundamental problems in accounting for currency. First, when the general ledger is out of balance with the cash inventory system, identifying the cause of differences is more difficult because of the inability to readily compare the transactions in the cash inventory system to the transactions in the general ledger. This step would be comparable to comparing the check and deposit activity, item by item, in a person's checkbook (the general ledger) to the items shown on their bank statement (the cash inventory system). Second, the ability to specifically identify timing differences that occur between the two systems due to the time lag between the receipt and processing of money is also made more difficult for the same reason. This second problem is the main reason that the receipts from circulation amounts are difficult to determine, and Bank officials stated that this contributed to amounts being forced instead of being independently determined from the cash inventory system.

In addition to these limitations, our work, which focused on identifying the problems of reporting currency activity and corrective actions taken at the L.A. Bank, did not include two other critical steps that would be needed to provide a comprehensive assessment of the Bank's accounting and internal controls over currency. These steps are a (1) general electronic data processing review to assess the effectiveness of the computer security controls over access to the Bank's general ledger and cash inventory systems to ensure that unauthorized access could not occur and go undetected or that such a risk is substantially minimized and (2) detailed review of the effectiveness of the physical safeguarding controls for controlling unauthorized access to the money.

Despite these limitations, we were able to perform a limited review of the reconciliations of the L.A. Bank's currency accounts for 6 judgmentally selected days in the October through December 1995 period and a walkthrough with bank employees for 1 day in June 1996 to enhance our understanding of the Bank's reconciliation process. As part of that review, we reviewed other management reports that highlighted differences between the data reported in the L.A. Bank's cash inventory and general ledger systems. Thus, we only reviewed the propriety of differences that FRB analysts identified when they performed their reconciliation.

Our efforts focused on assessing the propriety of how differences identified by the L.A. Bank were resolved and disposed. The problems identified in our review follow.

- On November 28, 1995, the L.A. Bank received a deposit of $432,000 from one depository institution. According to L.A. Bank officials, the depository institution received credit for $8,640,000 instead of the actual $432,000. Bank officials stated that they do not know whether the depository institution sent the wrong notification amount or whether L.A. Bank staff used the wrong notification for comparison. The initial L.A. Bank receiving team that counted the money knew that a $8,208,000 difference existed, but they overrode the system control in the cash inventory system and forwarded the money for further processing. Although this error was corrected when the problem was detected at the end of the day, this resulted in an erroneous entry being made into the L.A. Bank's general ledger for the $8,640,000 that increased the cash in the vault amount and the depository institution's account. L.A. Bank officials had no explanation for why this occurred.

  This error, however, should have been immediately corrected when the difference was identified by the L.A. Bank staff verifying the deposit. This raises concerns about the effectiveness of these physical controls even though the internal control of performing reconciliations at the end of the day worked effectively and found the problem. The internal control to verify the deposit and compare the amount counted to the amount reported by the depository institution identified this difference early in the process and before the wrong amount was recorded in the general ledger. However, the L.A. Bank staff that performed the count did not notify their supervisor and the supervisor did not contact the depository institution at that point. As a result, greater effort was required at the end of the day to resolve the differences.

- On October 17, 1995, there was a reconciling item that required a correction to the general ledger. This correction was made to increase the general ledger balance by $1,040,000 to make it agree with the balance of the cash inventory system. The correction was to record money returned to the vault that had been ordered by a depository institution but that was not sent to the institution by the end of the day. This transaction raises a number of concerns.

  The physical movement of individual customer orders for currency cannot be tracked through the L.A. Bank's cash inventory system because currency associated with numerous orders is tracked in an aggregate amount as it leaves the vault and is processed by teams preparing and shipping orders. For instance, the transfer of funds to the armored carrier for transport to the banks leaves as an aggregate carrier shipment amount, not as a series of single order amounts. As a result, credits and debits to financial institutions and associated entries to the general ledger are made at the end of the day, rather than when they leave the bank. When an order is cancelled, an adjustment must be made to the general ledger. At the L.A. Bank, certain clerks have the ability to delete transactions that would post to the general ledger at the end of the day, from the general ledger, where they will show up as "unposted" transactions. While the clerks are supposed to send a list of unposted transactions to the supervisor and attach documentation, such as cancelled shipping orders, the Bank relies heavily on the clerk to accurately and completely report these transactions.

While it is not unusual for a depository institution or armored carrier company to cancel an order, the manner in which these are corrected raises concerns. These corrections do not require documented supervisory approval as would other general ledger adjustments. Instead, through direct intervention on the L.A. Bank's computer system, certain L.A. Bank staff have the ability to cause an original transaction posted to the general ledger to subsequently be deleted. In addition, we could not find evidence that anyone at the Bank reviewed the general ledger for unposted transactions. Thus, certain staff could make unauthorized adjustments that could go undetected.

- On December 15, 1995, the L. A. Bank experienced an out-of-balance situation of $120,000 between its cash inventory system and its general ledger. The problem occurred because the cash inventory system assigned the same transaction number to two transactions and would not upload both of these transactions to the general ledger. As a result, one of the transactions did not post to the general ledger. A suspense item was created and the problem was researched.

  After researching the item, analysts found that a $120,000 deposit had been entered into holdover,[4] taken out of holdover, and then returned to holdover. One Bank official indicated that the underlying cause of the out-of-balance condition was a systemic defect in the cash inventory system that assigns the same transaction numbers to deposits that are placed in holdover twice in the same hour. Once identified, this problem was resolved. Following inquiries by our staff, an L.A. Bank official documented and reported the problem to the FRB in Atlanta, which is responsible for maintaining the cash inventory system.

[4]Holdover includes deposits to the L.A. Bank from financial institutions that cannot be immediately verified as to the number of bundles and straps of currency because of processing constraints.

These are examples of the problems we found in our review. The fact that we found problems while only attempting to review the reconciliations for a few days increases our concerns about the Bank's accounting practices and internal controls over currency.

Problems Found Demonstrate Need for Internal Control Reviews

The ultimate responsibility for good internal controls rests with management. Internal controls are an integral part of each system that management uses to regulate and guide its operations. In this sense, internal controls are management controls. Good internal controls are essential to achieving the proper conduct of business with full accountability for the resources made available. They also facilitate the achievement of management objectives by serving as checks and balances against undesired actions. In preventing negative consequences from occurring, internal controls help achieve the positive aims of managers.

As discussed previously, our findings concerning the L.A. Bank demonstrate the need for detailed internal control reviews at the L.A. Bank. They also raise concerns about the San Francisco District and its other branches and the other two District banks that use the same cash inventory system as the L.A. Bank—Philadelphia and Atlanta—and their respective branches. Further, they may signal concerns for the remaining banks or banks that use a less sophisticated system—for example, a Board of Governors official stated that two FRB banks account for their detailed cash activity manually.

Our report[5] on our audit of the Federal Reserve Bank of Dallas, 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 FRB[6] and FRAS,[7] 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.

[5]Federal Reserve Banks: Internal Control, Accounting, and Auditing Issues (GAO/AIMD-96-5, February 9, 1996).

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

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

In November 1994, the Board of Governors of the Federal Reserve System contracted for external, independent audits of the combined financial statements of the FRBs for calendar years 1995 through 1999. During these years, the financial statements of each of the FRBs will be audited once. In our recently issued reports,[8] we commended the Board for taking this step and expressed our belief that instituting regular, external independent audits will help enhance accountability over the operations of the Federal Reserve System. Additionally, this step would place the United States on a par with the practices of other central banks, such as those in France, Germany, and the United Kingdom. However, these financial audits will not include an internal control review designed to ensure that currency entrusted to the Federal Reserve Banks is accurately accounted for and controlled.

Conclusions

The problems identified in this report raise concerns over the quality of the internal control environment and the accuracy of the accounting for and controlling of money entrusted to the L.A. Bank and may signal problems in the other FRB banks that use this same system. It would be prudent for the Board of Governors to determine whether or not similar situations exist in the remaining FRBs as well.

The L.A. Bank has system design problems and procedures that should be improved to ensure a more accurate accounting of and effective control over such a liquid asset. Considering the large sums of money the L.A. Bank is responsible for managing and the problems identified from the limited audit procedures we performed, more detailed reviews of the L.A. Bank's operations are warranted. Detailed internal control reviews would provide independent assurance that the L.A. Bank has properly accounted for and controlled the money it manages. In this regard, to assure themselves and the public they serve about the integrity over accounting for and controlling the money in their possession, almost every major financial institution in this country has its internal controls scrutinized on a regular basis by its internal and external auditors.

Because of the system design problems and lack of discipline we identified in the cash processing operations of the L.A. Bank, we are concerned that the San Francisco District Bank and the other district banks that use the same cash inventory system could be experiencing similar problems. Such determinations were beyond the scope of our work. The FRB needs to

[8]See Federal Reserve System: Current and Future Challenges Require Systemwide Attention (GAO/GGD-96-128 June 17, 1996) and Federal Reserve Banks: Internal Control, Accounting, and Auditing Issues (GAO/AIMD-96-5, February 9, 1996).

consider the results of the detailed internal control reviews we believe are needed at the L.A. Bank in ensuring that cash operations at other banks are appropriately accounting for and controlling cash they are managing.

Recommendations

We recommend that the Chairman of the Board of Governors of the Federal Reserve System take the following actions.

- Require that the management of the Federal Reserve Bank of Los Angeles, working with its internal auditors, perform an immediate internal control assessment of its cash operations and reporting practices, including a review of the underlying systems. Bank management should prepare a report on the results of its assessment, including a written assertion on the effectiveness of its internal controls to ensure that the money it manages is appropriately accounted for, reported, and controlled. Also, as a component of the 1996 audit of the combined financial statements of the Federal Reserve Banks, require that the independent external auditors examine and provide an opinion on management's assertion about the effectiveness of the internal controls over cash operations at the L.A. Bank.
- Require that the San Francisco District Bank and the other two District Banks—Philadelphia and Atlanta—that use the same systems as the San Francisco Bank and their branches conduct reviews of their cash inventory systems and reporting practices to determine whether they have problems similar to those identified at the L.A. Bank.
- For the remaining Federal Reserve Banks, consider conducting internal control assessments to ensure the effectiveness of internal controls over their cash operations.
- Taking into account the continuing importance of proper controls and accountability for currency, consider conducting annual internal control assessments at all Federal Reserve Banks, including formal reporting by management and independent external auditor examination of management's assertion regarding the effectiveness of internal controls.
- To strengthen internal controls and provide for more accurate reporting, re-examine its policy that allows for the currency activity reports to be prepared within a plus or minus $3 million tolerance for accuracy.

Agency Comments and Our Evaluation

In commenting on a draft of this report, the FRB did not dispute our conclusions that the monthly currency activity reports for October through December 1995 were prepared incorrectly and that this was done at the direction of the L.A. Bank's management. The FRB also did not take issue with the fact that the L.A. Bank's management practice of forcing the numbers in the report to agree was not consistent with the Federal Reserve Board's policy guidance on how the monthly currency activity reports were to be prepared. The FRB stated that because of the issues raised in our report regarding accounting procedures at its L.A. Bank and our concerns about the integrity of financial accounting at the branch and at other FRBS, it has requested its external auditors to institute a thorough audit of this area. Also, consistent with our recommendations, the FRB stated that it will request its external auditors to examine and provide an opinion regarding the effectiveness of the internal controls over the cash operations at the Philadelphia and Atlanta Reserve Banks, which use the same cash inventory system as the L.A. Bank.

We agree with the FRB that such a thorough review is needed. It is critical that during this review, the FRB's external auditor comprehensively look at and test the internal controls over the banks' cash operations. This review should ensure that effective preventive and detection controls are in place and operating. Such controls should ensure that approvals, reviews, and other supervisory actions are properly documented when performed. In addition, this review should independently assess, including testing where appropriate, the physical safeguarding and computer security controls as well as the commitment of the respective bank's management towards instituting an effective internal control environment that requires strict adherence to established FRB policies.

The FRB took exception to two major conclusions in our report. First, it does not believe that there is a linkage between the preparation of its monthly currency activity reports and its financial accounting records. It stated that ". . . these reports are used for informational purposes only and are quite distinct from the financial accounting records of the bank." In addition, after noting that we concluded that such a linkage does exist, the FRB stated that ". . . GAO did not review the accuracy of the Branch's financial accounting records and provides no substantiation for this assertion."

We disagree with the FRB's statement that no linkage exists between the information in the monthly currency activity reports and its financial accounting records. We found that the cash inventory records, which make up the FRB's cash inventory system, were used to prepare the monthly currency activity reports we reviewed. The cash inventory records were updated with the same information[9] used to update the L.A. Bank's financial accounting records.

In attachment 2, page 9, of its comments on our report, the FRB describes this linkage in stating that "the data maintained in CAS (Cash Automation System), together with certain manual transactions, are used in three distinct ways: as a record of inventory for currency and coin (Inventory Files); as financial accounting records affecting depository institutions; and as a source of statistical information... (transaction/statistical files)." In its comments, the FRB refers to CAS as the Bank's cash inventory system and a source of statistical information. This is consistent with what we found. The monthly currency activity reports and the L.A. Bank's financial accounting records are prepared from the same source information—its cash inventory system—and are thereby linked.

Also, the FRB stated in its comments that daily reconciliations of its financial records to its cash inventory system are performed. However, the L.A. Bank was unable to make the two agree on a monthly basis for the period we reviewed and, therefore, forced the numbers on its monthly currency activity reports. This calls into question the effectiveness and/or completeness of the Bank's daily reconciliation procedures. If daily reconciliations of this information are performed, the monthly process should require nothing more than adding the daily activity together.

In an effort to show that its financial accounting records were correct, the FRB stated that on September 6, 1996, it performed a 100-percent cash inventory count of the L.A. Bank's cash holdings and concluded that the branch's balance sheet accurately reflected its currency and cash holdings. The FRB further stated that its internal financial examiners and internal auditors performed several internal reviews of its cash operations that determined that its internal controls were effective. The FRB asserted that these reviews were done in accordance with generally accepted auditing standards.

Performing a periodic physical inventory, as the FRB did on September 6, 1996, is a good internal control but doing so and the ensuing results are not directly relevant to the concerns identified in our report. A physical inventory count shows what was in the bank the day the count took place;

[9]As noted in attachment 2, page 9, of the Federal Reserve's comments on this report, most of the information that supports the L.A. Bank's accounting records (general ledger) and its statistical reports comes from its cash inventory system called the cash automation system. However, the cash inventory system and the L.A. Bank's general ledger have to be adjusted for a "very limited number of transactions" that are not recorded in its cash inventory system, and thus require manual entries to update both to get a full accounting of the Bank's cash position.

in this case, almost a year after the October through December 1995 period covered by our review. Also, our review did not have as its objective and was not designed to address whether there were cash shortages at the L.A. Bank. We, however, identified serious internal control and reporting problems and the L.A. Bank's inability to precisely account for the currency flowing through the Bank from month to month.

With respect to the two internal reviews cited by the FRB in its comment letter, the review reports had not been finalized at the time of our review and, according to an FRB official, would not be released in time for this report. As a result, we cannot comment on the scope, findings, conclusion, nor quality of the work performed by the FRB's internal examiners and internal auditors for these reports. Also, the FRB incorrectly asserted that these reviews were done in accordance with generally accepted auditing standards (GAAS). The work done does not meet the independence standards of GAAS applicable to external auditors.[10] Thus, while the financial examiners' and internal auditors' work may be considered independent for purposes of reporting to management, it should not be relied upon by external auditors. Under professional audit standards, we would have to review the internal financial examiners' and internal auditors' work in order to comment on their findings, scope of work, or audit quality.

The second major conclusion the FRB took exception with in commenting on a draft of this report was our recommendation that the Board reconsider its policy that allows for a $3 million tolerance for errors in preparing the monthly currency activity reports. The Board reiterated its view that the reports are for informational purposes only and that this level of precision is sufficient for the purposes that the reports are used. Further, it stated that the cost associated with achieving such precision far outweighed the benefit that would be derived from achieving it.

First, for broad informational purposes, such as calculating the money supply or monitoring payout patterns, the level of precision afforded by the $3 million tolerance would seem acceptable. We are not questioning this. Our concern is that the monthly currency activity reports are prepared from the Federal Reserve's accounting records, which brings into question the acceptability of any tolerance level.

[10]See Statement on Auditing Standards No. 65 "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."

Further, in our report, we express our concern over the L.A. Bank's inability to precisely account for currency activity from its cash inventory records when it attempted to do so. Even after L. A. Bank officials spent several months developing procedures to attempt to accurately account for this information, the inventory records did not agree with the general ledger. This means that either the L.A. Bank's new procedures for summarizing the activity in its cash inventory system were still flawed or that its financial records may be incorrect. This raises further concerns about the integrity of the internal control environment. The fact that the FRB asserts that it performs daily reconciliations of this information and cannot readily and precisely account for this activity also raises concerns. We reaffirm our recommendation that because of the linkage to the accounting records, the Federal Reserve reconsider its $3 million tolerance for accuracy.

In addition to the two major exceptions it took with our report, the FRB also asserted that the reviews conducted by its internal financial examiners and internal auditors concluded that (1) the reporting errors made by the L.A. branch have not affected the integrity of the Federal Reserve's financial statements, (2) these errors have not affected the Federal Reserve's calculation of the money supply, its conduct of monetary policy, or the amount of shipments of currency and coin to or from the branch, and (3) no money has been lost due to these errors, and no key decision-making has been compromised. These matters were not within the scope of our review and our report does not make any conclusions about any of them. As previously stated, the internal reviews cited by the FRB had not been completed and, therefore, not available for our review. Instead, our report focuses on the serious internal control problems found in the L.A. Bank. Notwithstanding our primary focus, we remain concerned that, until the L.A. Bank can resolve why it cannot reconcile the activity in its cash inventory records with the general ledger, it does not know and cannot be certain of the accuracy of its financial statements nor whether money has been lost.

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) 512-9510 if you or your staff have any questions. Appendix I contains comments we received from the Federal Reserve on a draft of this report and our response to those comments. Major contributors to this report are listed in appendix II.

Sincerely yours,

Gregory M. Holloway
Director, Governmentwide Audits

Contents

Letter		1
Appendix I Comments From the Board of Governors of the Federal Reserve System		28
Appendix II Major Contributors to This Report		52
Tables	Table 1: Excerpt From December 1995 Currency Activity Spreadsheet as Filed	7
	Table 2: Excerpt From December 1995 Currency Activity Spreadsheet as Revised	8

Abbreviations

BEP	Bureau of Engraving and Printing
CAS	Cash Automation System
FRAS	Federal Reserve Accounting System
FRB	Federal Reserve Bank
GAAS	generally accepted auditing standards

Comments From the Board of Governors of the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

ALAN GREENSPAN
CHAIRMAN

September 12, 1996

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

Re: Draft report of the General Accounting Office entitled "Federal Reserve Banks: Inaccurate Reporting of Currency at the Los Angeles Branch"

Dear Mr. Dodaro:

The Board of Governors appreciates this opportunity to comment on the draft report of the General Accounting Office (GAO) on errors made by the Los Angeles Branch of the Federal Reserve Bank of San Francisco in the cash reports it submitted to the Board. It is important to recognize that these reports are used for informational purposes only and are quite distinct from the financial accounting records of the Bank.

See comment 1.

Because of the issues raised by the GAO with respect to accounting procedures at the Los Angeles Branch and its concerns about the integrity of financial accounting at the Branch and at other Federal Reserve Banks, we have requested our external auditors, Coopers & Lybrand, to institute a thorough audit of this area. Our internal detailed examination of these issues has concluded that (1) the reporting errors made by the Los Angeles Branch have not affected the integrity of the Federal Reserve's financial statements (these data are independently verified daily); (2) these errors have not affected the Federal Reserve's calculation of the money supply, its conduct of monetary policy, or the amount of shipments of currency and coin to or from the Branch; and (3) no money has been lost due to these errors, and no key decision-making has been compromised.

See comment 2.

See comment 3.

Accordingly, we take exception to the two major conclusions in the draft GAO report. First, the draft report concludes that errors in the cash statistical reports of the Los Angeles Branch may be indicative of more serious problems with the financial integrity of its financial accounting records, and

- 2 -

See comment 3.

perhaps also those of other Reserve Banks. The GAO did not review the accuracy of the Branch's financial accounting records and provides no substantiation for this assertion. We would welcome a review by the GAO to determine whether or not its concerns have any foundation.

See comment 4.

To confirm that the Los Angeles Branch's financial statements accurately reflect its cash holdings, the Board of Governors ordered an unannounced 100 percent count of the Branch's currency and coin holdings last weekend. The Branch's vault was sealed on Friday afternoon and the count continued through Monday morning. The results of this count confirmed that the Branch's balance sheet accurately reflected its currency and coin holdings.

See comment 5.

In addition to the physical count, the Board's financial examiners recently completed their annual examination of the Branch, which included an audit of cash operations and the related financial records. These audits, which were performed in accordance with generally accepted auditing standards, were significantly more comprehensive than the recent review undertaken by the GAO. The examiners found that the accounting for the cash handled by the Branch was accurate and that proper safeguards and controls exist to ensure the integrity of the Branch's financial records.

The examiners concluded that there is no direct linkage between the Branch's accounting system and its statistical reports. Therefore, errors in the Branch's statistical reports do not suggest the existence of any problems with the accounting data. Furthermore, external auditors engaged to review the cash operations of the Los Angeles Branch concluded that there was no evidence to suggest that statistical errors affected the official records of the Bank's currency holdings.

See comment 6.

In addition, the San Francisco Reserve Bank's independent internal auditors performed two audits of the Los Angeles Branch's cash operations in 1995 and a special review of the statistical reporting process in 1996. These reviews, performed in accordance with generally accepted auditing standards and Institute of Internal Auditors *Standards for the Professional Practice of Internal Auditing*, indicated that the system of internal controls was generally satisfactory and did not reveal any problems that compromised the reliability and integrity of the Branch's financial information.

See comment 7.

Second, the draft report expresses concern that the Board does not require the same level of precision in the informational cash reports as it does in the Reserve Banks' financial statements. In particular, the draft report recommends that the Board re-examine its policy that allows for a $3 million

- 3 -

See comment 7.

tolerance in the reported level of month-end vault holdings. For these informational reports, we do not need precise numbers. We must weigh the accounting and staff costs associated with eliminating this tolerance against the insignificant benefits that would accrue. Board staff is taking steps, however, to improve its instructions to the Reserve Banks in order to reduce the potential for procedural errors in development of these informational reports. I would emphasize that while we allow a $3 million tolerance in our cash statistical reports, we permit no tolerance in the accuracy of the Reserve Banks' financial accounting records.

See comment 8.

The Federal Reserve maintains rigorous procedures and controls to ensure the accuracy of its accounting records and associated financial statements and has provided a high level of Reserve Bank, Board, and external audit attention to this area. We have enclosed additional information that discusses the controls and oversight over the Branch's financial accounting more fully. Attachment 2 describes the procedures and controls used by the Los Angeles Branch to ensure the integrity of its financial accounting records. Attachment 3 discusses the unannounced count of the Branch's coin and currency holdings. Attachment 4 summarizes the recent financial examination conducted by the Board's Washington D.C.-based financial examiners, which included the Branch's cash operations and accounting records. Attachment 5 outlines the conclusions reached by external auditors in their review of this area. Attachment 6 provides the assessment of the Bank's independent internal auditors regarding the effectiveness of the Branch's internal controls and integrity of its accounting records.

We have also enclosed, as Attachment 1, responses to observations and recommendations contained in the draft GAO report. We request that all of these attachments be included, along with this letter, as part of the GAO's final report.

Sincerely,

Attachment 1

Comments on Draft GAO Report

Integrity of Financial Accounting Information and Internal Controls

See comment 9.

The draft GAO report concludes that errors made by the Los Angeles Branch in compiling the monthly FR 160-CRSV statistical report raise concerns regarding the accuracy of the Branch's daily balance sheet, because the Branch uses source data in the Cash Automation System (CAS) to compile both the FR 160-CRSV and its balance sheet and the statistical reporting errors may be indicative of errors in these source data. The errors in the FR 160-CRSV report were not due to any problems with the source data in CAS. Rather, the errors in compiling the statistical reports generally were a result of procedural errors made by Branch staff. For example, the Branch (1) used the wrong data elements from CAS to compute data for the statistical report, (2) did not obtain all the necessary data elements from CAS and from manual reports to compute certain data elements in the statistical report, (3) entered some data on the incorrect line of the statistical report, and (4) did not check the reasonableness of the data computed before transmitting the reports to the Board. None of these errors call into question the integrity of the Bank's financial accounting records.

See comment 10.

As described in Attachments 2 through 6, the Los Angeles Branch maintains rigorous internal controls over its cash operations. The Board's financial examiners, the external auditors, and the Federal Reserve Bank of San Francisco's independent internal auditors have each reviewed the integrity of the Branch's financial accounting records and have found no evidence to question the effectiveness of the Branch's controls or the integrity of its financial records. The draft report provides no substantiation for its concerns. While the draft report cites one processing error and two processing exceptions as evidence of lax internal controls at the Branch, each example cited was identified by the Branch's system of compensating controls and safeguards and was resolved timely and accurately. Moreover, in each example cited, Branch management was involved in resolving the discrepancies.[1]

---

[1] The draft GAO report discusses a November 28, 1995, transaction in which a processing team mistakenly credited an institution for $8,640,000 instead of a lesser amount. The draft report does not state that the compensating controls that detected this error included management involvement and review. Supporting documentation had been provided to GAO staff during its field work.

See comment 11.

As part of its review, the GAO did not audit the integrity of the Branch's financial records or the physical controls that are essential to maintain that integrity. The draft report indicates that the GAO's efforts to reconcile the Branch's general ledger balances to its cash inventory system were hindered by the Branch's inability to provide the general ledger transaction history for its cash accounts. In fact, the Branch offered to provide the GAO with access to its on-line transaction records for the most recent nine days of activity, or to provide this information for a longer period of time in paper form immediately, or in electronic form within three weeks. The GAO chose to limit the scope of its review to exclude this work. The Federal Reserve remains willing to provide this information in electronic form to the GAO if it wishes to expand the scope of its work rather than simply speculating that there may be problems with the Branch's financial accounting records.

Assessment of Internal Controls

See comment 12.

The draft report recommends that the management of the Los Angeles Branch, working with its internal auditors, perform an immediate internal control assessment of its cash operations and reporting practices, including a review of the underlying systems, to ensure that its currency is appropriately accounted for, reported, and controlled. As explained elsewhere in this response, the Federal Reserve devotes considerable resources, including the Board's financial examiners, external auditors, and the Banks' internal auditors, to audit the cash operations of the Reserve Banks and the integrity of their financial accounting records. Based upon the results of recent audit attentions, we believe that the Los Angeles Branch maintains an effective internal control structure over its cash operations. The Federal Reserve will continue its close attention to these areas in the future.

See comment 13.

The draft report also discusses a processing exception involving a canceled currency order for $1,040,000, but fails to mention the management involvement that occurred in the disposition of the transaction. In accordance with established procedures, the currency was returned to vault inventory and management instructed the proof clerk to delete the debit for the order. In addition, documentation of the actions taken by the proof clerk were included in the daily close-out report, which was distributed and reviewed by department management. Documentation of these steps was reviewed with GAO staff during its field work.

We believe that inclusion of this additional information in the final report is necessary to enable the reader to form an informed assessment as to the effectiveness and integrity of the Branch's internal controls.

See comment 14.

The draft report also recommends that, as part of its 1996 audit of the combined financial statements of the Reserve Banks, the external auditors examine and provide an opinion on management's assertion about the effectiveness of these internal controls at the Los Angeles Branch. The external auditors have already concluded that there was no evidence to suggest that statistical errors affected the official records of the Bank's cash holdings. Moreover, the recent count of all of the Branch's coin and currency holdings provides additional verification of the effectiveness of the Branch's internal controls and the accuracy of its financial statements. Nonetheless, the Board will direct its external auditors to examine and provide an opinion regarding the effectiveness of the internal controls over the Branch's cash operations, as well as those of the Philadephia and Atlanta Reserve Banks, which also use the CAS system.

Reviews of Other Reserve Bank Cash Operations

The draft GAO report recommends that Federal Reserve offices that use the Cash Automation System conduct reviews of the system and their reporting practices to determine whether they have problems similar to those identified at the Los Angeles Branch. The Philadelphia, Atlanta, and San Francisco Reserve Banks have recently conducted extensive reviews of the procedures used to compile the FR 160-CSRV reports and have determined that they currently use appropriate procedures to compile these reports.

The draft GAO report also recommends that the remaining Reserve Banks conduct internal control assessments and that all Reserve Banks conduct annual internal control assessments. The Federal Reserve regularly assesses the effectiveness of the internal controls over the cash operations at all Reserve Bank offices. The process includes recurring reviews by the internal auditors, annual assessments by the Board's financial examinations, periodic procedural reviews by the Board's cash section, and reviews of the currency destruction operation by the Department of Treasury. These attentions are augmented by financial statement audits of the Reserve Banks by external auditors.

Required Level of Precision in Cash Statistical Reports

See comment 15.

Finally, the draft GAO report suggests that the Board re-examine its policy that allows for the currency activity reports to be prepared within a $3 million tolerance to strengthen internal controls and to provide for more accurate reporting. The draft report assumes that it is necessary to require the same level of precision in the Reserve Banks' cash statistical reports as there is in the Reserve Banks' financial statements.

See comment 15.

These reports are used for informational purposes only. For example, they are used to monitor payout patterns and to assess the currency stock needs of each Reserve Bank office. This information has been helpful, for example, in assessing the most effective way to handle the introduction of the new design currency. These data are also used for historical trend analysis that is useful in projecting future receipt and payout levels and are used as input to evaluations of the relative efficiency of Reserve Bank cash operations. In addition, Board staff uses these data to respond to requests by Congress and the public for information on payments and receipts of currency and coin at the Reserve Banks and the Board publishes summary statistics derived from these data annually. Finally, Board staff shares cash statistical data with several law enforcement agencies, which use these data to track cash flows throughout the country and to identify regions of the country that are net receivers of currency.[2] None of these uses require the same level of precision as the Federal Reserve demands of its financial accounting records.

The Los Angeles Branch's errors during the fourth quarter of 1995 changed its reported production volume by slightly less than one percent. Errors of this magnitude are not sufficiently material to affect the Board's published statistics or decisions made based on analysis of these data. We have also confirmed that the errors in the Los Angeles Branch data did not affect the activities of the law enforcement agencies that use these data for analytical purposes. Given the uses of the information in the cash statistical reports, it is not necessary or cost effective to subject the compilation of these reports to the same level of rigorous controls that are used to ensure the accuracy of the Bank's financial information, which are described in Attachment 1.

The purpose of the $3 million tolerance between the reported amount of currency on hand at month-end in the FR 160-CSRV and the amount as reported on the Branch's balance sheet is to facilitate timely reporting of the information by the Reserve Banks, to allow for rounding of the amounts reported,[3] and to eliminate the need for the Reserve Banks to employ extensive procedures that would be required to report the information with the same precision as our accounting system. While we could require each Reserve Bank to submit statistical reports with such a level of precision, we believe that the costs associated with the additional effort required to achieve this goal far outweighs

---

[2] These data are supplemented by more detailed data provided by the Reserve Banks to these government agencies.

[3] Because the cash statistical reports do not require the same level of precision as the Bank's financial accounting records, information is reported in thousands of dollars before transmission to the Board.

See comment 16.

the insubstantial benefits that would be derived.

Determination of Receipts from Circulation Line of FR 160-CSRV

The draft GAO report states that the receipts from circulation were not taken from the Los Angeles Branch's cash inventory records but rather "forced" to ensure that the currency activity report agreed with the balance sheet. Reserve Banks prepare the FR 160-CSRV report by obtaining information from their electronic cash inventory system (e.g., CAS) as well as from manual records, comparing many line items to other sources of information, including the balance sheet's vault balance, and making adjustments to the statistical data as necessary. They derive Receipts from Circulation based on the other data being reported and check this derived amount for reasonableness by comparing it to the gross receipts as stated in their electronic and/or manual cash inventory records. This methodology is less time consuming than calculating Receipts from Circulation using all related activity.

- 9 -

Attachment 2

Currency Accounting Process and Controls at the Los Angeles Branch

In order to safeguard and accurately account for currency inventory, the Los Angeles Branch of the Federal Reserve Bank of San Francisco uses an effective combination of: (1) accounting system design, (2) independent entry and verification of data, (3) physical controls, (4) automated controls, and (5) management review. The Federal Reserve's Integrated Accounting System (IAS) design requires separation of duties, the use of control accounts for certain entries, and strict access controls. Physical controls include separation of duty, dual custody of currency deposits and shipments, and very limited access to currency. The Cash Automation System (CAS) records each step of the Branch's cash operations, from receipt through shipment of currency and coin. Management review includes requirements for escalation of potential problems, approvals, and verification. As a result of these procedures and controls, reliability and integrity of accounting for currency is ensured.

Information used to ensure accurate accounting is obtained from CAS. A very limited number of transactions are not recorded in CAS, and thus require the preparation of manual entries for accounting and statistical purposes. The data maintained in CAS, together with certain manual transactions, are used in three distinct ways: as a record of inventory for currency and coin (*inventory files*); as financial accounting records affecting depository institutions, the Federal Reserve, and the Treasury (*financial files*); and as a source of statistical information that is used to assess future currency stock needs, monitor payout patterns, and perform other analyses as needed by the Board of Governors and Bank staff (*transaction/statistical files*).

Described below is the process for handling and accounting for currency transactions. The process begins when a depository institution initiates a currency deposit notification or an order request. Throughout the process, there are automated system (CAS), procedural, and control (accounting and physical) check points to ensure integrity in processes and outcomes. Woven into the process are four separate independent verifications performed by staff and management each day. The process allows for timely identification and resolution of accounting-related problems. The process includes the following steps described below.

1. Depository institutions must submit electronically a notification of a deposit or an order to the Federal Reserve Bank. The notification includes the dollar amount and denominational breakdown for the deposit or order.

[Automated controls]

2. An armored carrier delivers the deposits to the Reserve Bank. A two-person receiving team enters into CAS the total value of the deposits and the number of bags received from the armored carrier. One team member then counts the number of straps (100 notes wrapped together) in each deposit and enters the value of each deposit into CAS. The total dollar amount entered by this team member is compared to the amount in the original notification provided by the depository institution. The other team member completes a second independent count and enters into CAS a denominational breakdown of the deposit. CAS records the identity of the team member making each entry. The same process occurs with outgoing orders. The depository institution's account is credited for the deposit or debited for the order. The offset to this entry is a debit or credit to the currency inventory account. [Physical control by two individuals, independent data entry, and automated access controls]

3. If the deposit total entered by the team does not agree with the depository institution's notification total, CAS prompts the team to notify management and investigate the discrepancy. If the team determines that the depository institution's notification does not agree with the value of the actual deposit, a difference entry is posted to the institution's account following management approval. An independent service representative contacts the depository institution regarding the discrepancy. [Automated control]

4. After processing all deposits, the team does a physical denominational count of its total holdings. The team enters the count into CAS, which automatically compares the balance count to the total dollar amount of the armored carrier transactions described in Step 2. The two values must be equal for the team's holdings to balance. [Physical control of currency, automated control, and independent data entry]

5. At the end of the business day, each team must produce a unit proof, which lists the team's current inventory balance and all transactions performed that day. CAS verifies that the inventory (from the *inventory files*) and transaction totals (from the *transaction/statistical files*) agree before the team can produce its final unit proof. [Automated control]

6. **First Level of Verification.** Transactions related to currency destroyed, paid into circulation, and/or received from circulation are listed on the final unit proof, and compared to source documents by an independent proof clerk following the close of the team's business day. Any potential discrepancies are brought immediately to management's attention for resolution.

- 11 -

[Separation of duties, independent verification, and management review]

7. Once all teams have produced their unit proofs, the independent proof clerk prepares the department unit proof. The department unit proof lists the current inventory balance for each of the department's teams. CAS verifies that all teams have produced their final unit proofs, and the department inventory and transaction totals agree before the department proof can be produced. [Automated control and separation of duties]

8. The independent proof clerk then submits entries to IAS for the depository institutions' and the department's general ledger accounts. Data from manual entries are entered directly into IAS. [Use of control accounts for manual entries]

9. **Second Level of Verification.** The independent proof clerk compares the department inventory total to the calculated balance from CAS. The calculated balance is determined by taking the ending inventory from the previous day and adding/subtracting for the current day's transactions. The two totals must be equal. [Independent verification]

10. **Third Level of Verification.** The independent proof clerk then compares the department inventory total to the total reflected in IAS. The two totals must be equal. Throughout the independent proof process, management is informed of any out-of-balance situations. [Separation of duties, independent verification, and management review]

11. **Fourth Level of Verification.** The following business day, department management compares the total dollar amounts, as reflected on department source documents, to the general ledger account totals reported by the Accounting Department. Any differences are identified, researched, and corrected immediately. Once this review is completed and the general ledger account totals are verified, the information is posted to the Bank's balance sheet (FR34). In addition, twice a month the Cash Administration Department management reviews the general ledger balance and supporting documentation and provides a certification of this review to the Accounting Department. [Independent verification and management review]

12. Depository institutions have the ability to verify their transaction by reviewing the debits and credits that appear on their daily Statement of Account Activity and on other automated account information systems. [Independent verification by depository institution]

These steps, combined with the safeguards and controls described earlier, ensure that depository institutions, the Treasury, and the Federal Reserve can be confident in the accuracy, reliability, and integrity of the financial accounts.

- 13 -

Attachment 3

Count of Cash Holdings of the Los Angeles Branch

The Chairman of the Board of Governors approved a plan to conduct a special examination of the Los Angeles Branch to determine whether its currency and coin holdings were stated accurately in its financial records as of the close of business September 6, 1996. The Board's Washington D.C.-based financial examiners performed a 100 percent count of the currency and coin holdings of the Branch, with the assistance of the San Francisco internal audit function. Because of the size of the Los Angeles cash operation and the need to complete the count expeditiously to minimize any disruption in processing, a total of forty examiners and auditors were used to conduct this examination.

Consistent with procedures for conducting verifications of valuables, no advance announcement was made to management and staff at the Federal Reserve Bank of San Francisco or its Los Angeles Branch. The Branch's vault was sealed on Friday afternoon, September 6, and the count continued through Monday morning, September 9. This special examination was conducted in accordance with generally accepted auditing standards.

The count of the Branch's currency and coin holdings by the examination team equalled the amount as stated on the Branch's balance sheet. Therefore, the examiners concluded that the Branch's financial records accurately reflect its actual cash holdings.

As is noted in Attachment 4, the Board's financial examiners conducted a regular examination attention of the Los Angeles cash department in July/August 1996. The examiners concluded that accounting for cash by the Branch was accurate and that the internal controls were effective to ensure the integrity of the financial records. The results of the complete inventory provide additional support for that opinion.

Attachment 4

**Board Financial Examination of
the Los Angeles Branch**

The currency operation of the Los Angeles Branch of the Federal Reserve Bank of San Francisco was recently reviewed by the Federal Reserve Board's financial examination staff (July 16 through August 8, 1996), as part of the Board's annual financial examination of each Reserve Bank. This attention was performed in accordance with generally accepted auditing standards.

Within the scope of the review,[1] the examiners concluded that (1) the financial records contained no material mis-statements, (2) account balancing and proof processes are appropriate with proper separation of duties, (3) the system of internal controls is effective, (4) operations comply with Federal Reserve System and Treasury requirements, and (5) operations are being effectively supervised. Also, the review determined that there are no direct relationships between the accounting system and the statistical reports.

The examination included an assessment of controls in place for all aspects of currency operations, including processing of incoming deposits and outgoing shipments as well as internal processing and transfers and currency storage. Also, the review included the observation of the physical conditions under which valuables are stored. The accuracy of financial accounting data was tested by randomly selecting a business day and reconstructing the transaction proof process and the generation of currency balances by the automated subsidiary accounting system with subsequent verification to the general ledger accounts.

The automated subsidiary accounting system maintains detailed records of accounting transactions for each day and periodically updates the general ledger accounts within the Branch's accounting system. Attention to this area included a review of the data-entry process by various functions in the cash department, the subsequent end-of-day independent proof process for these

---

[1] The scope of the work performed was established through an on-site assessment of risk and the condition of operations and controls as indicated by reviews of management information reports, internal audits, and preliminary surveys of systems of internal control. Based on this information, an examination plan was developed to provide sufficient coverage to ensure that an opinion could be rendered on the balance sheet accounts and supporting general ledger, and on the system of internal controls applicable to currency and coin held by the Los Angeles Branch.

functions, and the update of the general ledger accounts. The examiners also reviewed the process for collecting statistical data and the generation of statistical reports.

- 16 -

Attachment 5

External Auditor Review of the Los Angeles Branch

The Board of Governors has engaged an independent external accounting firm, Coopers & Lybrand, to audit and certify the combined financial statements of the Federal Reserve Banks. The firm issued an unqualified opinion on the 1995 financial statements, as prepared in accordance with the financial accounting manual for the Reserve Banks. The Board recently requested that this firm perform a limited review of the Cash Department of the Los Angeles Branch to determine whether data errors identified in the compilation of statistical reports also affected the financial accounts reflecting currency holdings.

As part of this review, the firm conducted field work at the Board to gain an understanding of the purpose and use of the statistical reports and the effect of reporting errors on reliability and utilization of the reports. Field work conducted at the Los Angeles Branch focused on the recording and reporting of data, as well as procedural errors and other causes that resulted in erroneous statistical reports. The firm also reviewed revised procedures in order to determine how errors in recording and reporting were addressed.

The external auditors also gained an understanding of whether the statistical errors had any implications on the financial reporting system. The auditors considered the special review performed by the Bank's internal auditors that assessed the reliability of the statistical information through verification of financial data and comparison of these data to statistical data that generated statistical reports. The majority of evidential matter used in this review was obtained through inquiry and observation. The firm did not initiate the formal process of verifying the various related statements and representations during this limited attention.

Based on this review, the external auditors informed the Board that they identified no factors that would indicate the potential for inaccuracies or misstatements of the Branch's cash position as reported in the general ledger or in the balance sheet.

Attachment 6

Federal Reserve Bank of San Francisco Internal Audits of the Los Angeles Branch

In addition to the attention given to Reserve Bank cash operations by the Board's financial examiners and external auditors, the audit function of each Reserve Bank also reviews these operations closely. A Reserve Bank's auditors are independent of Bank management and report directly to the audit committee of that Bank's board of directors.

The following describes relevant recent audit attentions by the Audit Department of the Federal Reserve Bank of San Francisco. These audits were performed in accordance with generally accepted auditing standards and Institute of Internal Auditors *Standards for the Professional Practice of Internal Auditing*. The Bank's auditors have found no evidence that would indicate that the internal controls or the reliability and integrity of the financial information of the Los Angeles Branch have been compromised.

Los Angeles Branch Cash Operations. The Audit Department of the Federal Reserve Bank of San Francisco performed two independent, comprehensive audits of the Los Angeles Branch cash operation during 1995. The audit objectives were to determine the adequacy and effectiveness of internal controls. The scope included: (1) a review of general electronic data processing to assess the effectiveness of computer security controls; (2) a detailed review of the effectiveness of the safeguarding of assets; (3) an inventory of selected cash holdings; (4) a review for compliance with Treasury, Board of Governors, and Twelfth District policies and procedures; (5) a review of the economy and efficiency of operations; and (6) a review of local area network and personal computer controls. Procedures did not include verifying the Cash Department general ledger account balances as reliance was placed on Board of Governors' work for general ledger account verification.

Auditors reviewed access to the Bank's general ledger and cash inventory systems to ensure unauthorized access could not occur and go undetected or that such a risk is substantially minimized. Procedures consisted of reviewing the Cash Automation System application, operating system security, technical processing of the computer platform that processes cash transactions, and ACF2 security of the Integrated Accounting System as it relates to the cash operation.

These audits also included a detailed analysis of the effectiveness of the physical controls for controlling access to the cash department, valuables, and department records. The currency and coin receiving, processing, and shipping activities were reviewed for compliance with Federal Reserve System, United States Treasury, and Twelfth District valuables-handling procedures. Due to the informational nature of the FR 160-CRSV Currency Activity Reports and the relatively low risk associated with their use, no audit attention was given to the FR 160-CRSV reports during these audits.

System Audit of Integrated Accounting System. Additionally, during 1995, a coordinated Systemwide audit was conducted of the Integrated Accounting System. The review included evaluating manual and automated controls for computer security and access to the general ledger through a 100 percent review of ACF2 access to the Integrated Accounting System by each District, including their Branches.

Audit Opinion. The Federal Reserve Bank of San Francisco audit function concluded that the system of internal controls was generally satisfactory. The selected inventories balanced to the Bank's balance sheet. While these audits identified issues for management to take corrective action, none of the issues noted compromised the system of internal controls or the reliability and integrity of financial information. The Branch implemented the recommended corrective actions immediately.

Audit of Cash Statistical Reports. Federal Reserve Bank of San Francisco auditors also recently performed an independent comprehensive special review of the Twelfth District's monthly currency activity FR 160-CRSV reporting process. The Bank's auditors focused primarily on the Los Angeles Branch, but also reviewed other District Branches' reporting processes.

The objectives of the review were to determine the reliability of information submitted to the Board of Governors on the monthly FR 160-CRSV Currency Activity Reports. To accomplish this objective, the auditors verified general ledger transactions to source documents and the Bank's balance sheet for several reporting periods in 1995 and 1996. They then compared this information to the Branch-developed computer statistical extract programs (Cash Automation System queries). The auditors also reviewed the training provided to staff responsible for extracting information submitted to the Board of Governors.

While this review is not complete, preliminary results indicate that the Bank's balance sheet was correct. The review indicated errors were made in the FR160-CRSV reports submitted to the Board of Governors; however, these errors appear to have been caused by how information was extracted and summarized by category. In the opinion of the Bank's auditors, additional training and monitoring would have eliminated these errors. The auditors have not identified any systemic design problems in the Cash Automation System that could compromise the reliability and integrity of financial information.

The following are comments on the Board of Governors of the Federal Reserve System's letter dated September 12, 1996.

GAO Comments

1. As discussed throughout this report and as described in attachment 2, page 9, second paragraph, of the Federal Reserve's response to this report, the basis for the information reported in the monthly currency activity reports and the L.A. Bank's financial accounting records is the same—its cash inventory system called the Cash Automation System. Because this information comes from the same source, it should agree; however, we found that the L.A. Bank could not make the information agree without forcing numbers.

2. Because the FRB could not provide the detailed general ledger transactions that had been recorded for the currency in its financial accounting records, we were unable to determine whether the financial statements and the related general ledger were accurate. However, the FRB's inability to reconcile activity in its cash inventory system with the general ledger without forcing numbers and the serious internal control problems that we identified in our review raise questions about whether the cash inventory records, the L.A. Bank's new procedures for summarizing the information from its cash inventory records, the general ledger, or all three are incorrect. Beyond the concerns we raised about the integrity of its accounting and internal controls, other potential impacts on the FRB of the errors we identified were beyond the scope of our review. In particular, without access to the general ledger transactions and without performing an independent review of physical safeguarding and computer security controls, we would be unable to determine whether money was lost or unreasonably exposed to loss due to the problems we found.

Further, the currency activity reports and the underlying systems that they are generated from constitute the Federal Reserve's only detailed records of currency transactions throughout the Federal Reserve System. Therefore, to the extent that the information on monthly currency movement in and out of Federal Reserve Banks is provided to Federal Reserve management, the Congress, and other external users of this information, it would be based on data from the currency activity reports. The impact of errors in this reporting on external users of this information was also beyond the scope of our review.

3. While periodically performing physical inventory counts of the L.A. Bank's vault is a good internal control, such a count only shows that what

was physically in the vault that day equalled what was in its cash inventory and general ledger records the day of the count—in this instance, September 6, 1996. This does not prove that the coin and currency that moved through the Bank at all other times was properly safeguarded and accounted for. Without the ability to consistently summarize currency activity and effective internal controls, the physical inventory of the vault, alone, is insufficient to provide assurances that the FRB is accurately accounting for the billions of dollars that flow through the Bank each week.

4. In the "Agency Comments and Our Evaluation" section of this report, we noted that our review identified serious internal control problems and pointed to the inability of the L.A. Bank to summarize currency activity on a monthly basis. It is our view that these issues do, in fact, raise serious concerns about the integrity of its accounting and internal controls.

Because two other district banks and their branches use the same cash inventory system and some of the problems in currency reporting are linked to the limitations in the design of this system, we suggest that problems may also have occurred in the San Francisco District Bank and its other branches and the other two districts using the system. It is worth noting that the gravity of the concerns raised at the L.A. Bank appear to make it prudent to also investigate whether there are problems in these other banks.

When we requested their general ledger transactions, we were told by L.A. Bank officials that to provide it in hard copy would be impractical, and they strongly discouraged producing the information, because it would amount to reams of material. When we then requested the records in electronic format, FRB officials stated that it would be burdensome and very difficult and that they did not have the staff to provide it in time for our review. It is for these reasons that we limited the scope of our review. FRB staff also had difficulty retrieving information we requested to support the reconciliations for 2 of the 6 days that we reviewed. L.A. Bank officials have still not located the report containing the ending balance of the amount of currency in the vault as reported in its cash inventory system for one of the days selected in our review, identified earlier in this report, and certain other information we requested.

5. With respect to the two internal reviews cited by the FRB in its comment letter, the review reports had not been finalized at the time of our review and, according to an FRB official, would not be released in time for this

report. As a result, we cannot comment on the scope, findings, conclusions, nor quality of the work performed by the FRB's internal examiners and internal auditors related to these reports. Also, the FRB incorrectly asserted that these reviews were done in accordance with generally accepted auditing standards (GAAS). The work done does not meet the independence standards of GAAS applicable to external auditors.[1] Thus, while the financial examiners' and internal auditors' work may be considered independent for purposes of reporting to management, it cannot be relied upon by external auditors. Under professional audit standards, we would have to review the internal financial examiners' and internal auditors' work in order to comment on their findings, scope of work, or audit quality.

Finally, as noted in attachment 5, third paragraph, of the Federal Reserve's response to this report, the work performed by the external auditor was primarily based on representations made by Federal Reserve officials and observations. The external auditor obtained the majority of evidential matter used in its review through inquiry and observation. It did not initiate the formal process of verifying the various related statements and representations during its limited review. In addition, as summarized by Federal Reserve officials in attachment 5, the external auditors informed the Board that "they identified no factors that would indicate the potential for inaccuracies or misstatements of the Branch's cash position as reported in the general ledger or in the balance sheet." They did not say that "there was no evidence to suggest that statistical errors affected the official records of the Bank's currency holdings."

Similar to the Board's financial examiner review, the external auditor's report was not provided as part of the FRB's response nor was it provided to us during our review. Thus, we cannot specifically comment on the report's scope, findings, conclusions, or contextual presentation.

6. See discussion in comment 5 above. The issue of independence applies to both the San Francisco Reserve Bank's internal auditors and its financial examiners.

7. See our responses made in the "Agency Comments and Our Evaluation" section of this report.

[1]See Statement on Auditing Standards No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."

8. We did not conduct a comprehensive review of procedures and controls that are in place to ensure the accuracy of its accounting records and associated financial statements. In particular, we did not review the L.A. Bank's computer security controls for preventing unauthorized access to its general ledger and cash inventory system or its physical access controls for ensuring that the money it manages is protected from theft and misappropriation. We agree with FRB officials that a number of controls are in place. However, we believe that the errors and internal control problems identified in this report raise serious questions about the effectiveness of the controls in place and the need for additional controls to ensure the accuracy of its accounting and to provide assurance that the money flowing through the Bank is safeguarded.

9. We agree that staff made a number of errors in preparing the currency activity reports. We believe that the actions taken to improve supervisory review and reduce the amount of data that must be collected from manual logs will likely reduce errors in reporting. However, we do not agree that all of the errors were due to procedural errors made by L.A. Bank staff. In fact, the most troublesome aspect of how the reports were prepared was that Bank management directed staff to force the number for receipts from circulation to ensure that the currency activity report agreed with the daily balance sheet for the last day of the month. This is troublesome because it showed that the Bank had difficulty summarizing receipts from circulation independently and it also obscured other errors in the report.

10. See our responses in the "Agency Comments and Our Evaluation" section of this report and our responses to comments 4, 5, 6, and 8. Further, while Bank management ultimately took actions to improve how the currency activity reports were prepared, it was at their direction that staff forced the number for receipts from circulation. Further, we did not find that they were rigorous in their followup of internal control weaknesses. The particular example cited in the comments is one that raised our concern. In an interview with FRB officials, we were told that a processing team intentionally overrode the physical controls in the cash inventory system and processed a deposit despite the fact that the amount they counted did not agree with the amount in the depository institution's deposit notification. We were not told that they mistakenly credited an institution, as cited in the comments. In addition, at the time of our interview in August 1996, Bank officials said that they did not know what caused the out-of-balance situation that led the team to override the system in November 1995. It would seem that tracking down the cause of such a mistake and what impact it may have on other transactions would

have been a top management priority and it was not. Finally, while we note in the report that the mistake was caught at the end of the day through the reconciliation, we also state that the difference should have been identified and corrected immediately when it was found by staff.

11. See our response to comment 3.

12. See our response to comments 4, 5, 6, 8, and 10.

13. We stated in this report that there was no evidence that management reviewed or approved the transactions done by unit proof clerks to delete transactions from the general ledger. Nothing was provided to us to show otherwise, other than L.A. Bank management officials asserting that they did it. We reaffirm this finding.

14. See our response to comments 4 and 5.

15. See our response in the “Agency Comments and Our Evaluation” section of this report and our response to comments 1 and 2.

16. The FRB comment addresses what it states are its new procedures for preparing the monthly currency activity reports. However, our report addresses the procedures used to prepare the monthly currency activity reports for October through December 1995. These amounts were forced and the L.A. Bank did not perform any reasonableness check for the receipts from circulation amount to see if it was within the $3 million tolerance—this is the line item in the report that was and continues to be used to make the report equal the general ledger balance. The practice of checking this amount for reasonableness to verify that it was within the allowed tolerance was begun as part of new procedures that were implemented in 1996.

Major Contributors to This Report

San Francisco Regional Office

Lynne M. Pollock, Assistant Director
Karen L. Seymour, Evaluator in Charge
Julie DeVault, Evaluator
Eugene P. Buchert, Senior Evaluator

Los Angeles Regional Office

Jan M. Brock, Senior Auditor
Ted C. Hu, Auditor
Stacey C. Osborn, Auditor

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

http://www.gao.gov

PRINTED ON RECYCLED PAPER