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Auditing Federal Reserve Banks*

By FRANCIS OAKEY

There should always be excellent reasons for selecting one's own work as a topic for discussion. I hesitated therefore to prepare a paper on *Auditing Federal Reserve Banks* until it occurred to me that on account of its extraordinary aspects the subject might be interesting to the members of the Institute. In the first place a federal reserve bank is, as far as I have observed, the only going concern in this country in which the assets and liabilities can be completely verified. By a complete verification I mean one that permits the auditor to give a certificate unqualified by opinion, approximation or exception. In the second place, one of the federal reserve banks, namely that at New York, is the largest bank, if not the largest business corporation, in the world, when measured by total resources. On June 30th of this year the total resources of the largest banks in the world expressed in dollars were approximately as follows:

Federal Reserve Bank of New York.....	\$1,544,000,000
London Joint City & Midland Bank.....	1,514,000,000
Lloyds Bank	1,336,000,000
Barclay's Bank	1,300,000,000

I have no statements of the Bank of England, the Bank of France and the Imperial Bank of Germany as of June 30, 1921. Their statements immediately after that date show total resources as follows:

Bank of England	July 20, 1921	\$1,217,000,000
Bank of France	July 16, 1921	966,000,000
Imperial Bank of Germany	July 7, 1921	1,447,000,000

Finally, the broader question of safeguarding the resources of the federal reserve system by a process of audit may be of interest to you. These resources have aggregated nearly six and one-half billions of dollars and the fiduciary holdings several billions more.

Before discussing the auditing problem, it is well to outline briefly the organization, functions and powers of federal reserve banks.

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The country is divided into twelve federal reserve districts, in each of which a federal reserve bank is established. The capital stock of a federal reserve bank is subscribed by the member banks in its district, each member bank being required to subscribe to an amount of capital stock equal to 6 per cent. of its capital and surplus. All national banks are required by the federal reserve act to become members. State banks and trust companies may become members by complying with certain requirements. Each federal reserve bank has a board of directors of nine members, six of whom are chosen by the member banks, and three are designated by the federal reserve board. One member appointed by the federal reserve board is chairman of the board of directors and also federal reserve agent. This officer in his capacity as federal reserve agent is the representative of the federal reserve board. His duties include the issuance of federal reserve notes to the federal reserve bank to which he is appointed upon receipt of collateral consisting of gold or eligible commercial paper. The federal reserve board is the regulating and supervising body over all the federal reserve banks; it consists of seven members including the secretary of the treasury and the comptroller of the currency, who are members *ex officio*, and five members appointed by the president with the advice and consent of the senate.

The duties of a federal reserve bank consist of holding the reserves of member banks, receiving deposits from and paying cheques of member banks; it has the power to rediscount eligible commercial paper offered by member banks, to make advances to member banks on their own notes, to issue federal reserve notes secured by gold or by eligible commercial paper and gold, to issue federal reserve bank notes secured by United States bonds, to purchase securities for investment, to buy and sell acceptances and gold in the open market, to collect for member banks cheques, notes and drafts. It is also its duty to act as fiscal agent of the United States.

The discharge of these functions results in the possession of cash, securities and commercial paper under various responsibilities so that an effective examination of a federal reserve bank involves much more than the verification of the bank's assets and liabilities. More concretely stated, such an examination consists of four parts, namely:

1. The verification of assets and liabilities;
2. The examination of securities held in safekeeping;

3. The examination of securities held as fiscal agent of the United States government;
 4. The examination of the federal reserve agent's department.
- Let us consider these in order.

VERIFICATION OF ASSETS AND LIABILITIES

The transactions of a federal reserve bank that affect its own assets and liabilities are entirely with other banks, with the United States treasury and with certain foreign governments. The open-market operations in acceptances and securities are, of course, often with bankers and brokers, but are in all cases cash transactions. The result is that the liabilities on the books consist solely of the following classes:

1. Outstanding federal reserve notes,
2. Outstanding federal reserve bank notes,
3. Balances due member banks,
4. Balances due foreign banks,
5. Balances due the United States treasury,
6. Balances due foreign governments.

Outstanding federal reserve notes and bank notes can be verified by direct confirmation with the United States treasury. All the other liabilities can be verified by confirmations received direct from the creditors in the form of statements, reconciliements or letters. In this way it is not only practicable to effect a complete verification of all liabilities shown by the books but also to discover any liability that may exist that the books may not reveal, since confirmations can be obtained from every bank in the district. In commercial practice it is not only impracticable but theoretically impossible to establish all liabilities and to verify them by confirmations from individual depositors or trade creditors. Such confirmations must be confined to the names that appear in the books, and even if these are confirmed in full—a rare achievement in a concern of any size—there may still remain liabilities neither shown by the books nor reported by the client.

Turning to the resources we find that they consist of eight main classes, namely: (1) gold reserves; (2) other cash reserves consisting of legal tender notes, silver coin and certificates; (3) miscellaneous currency and minor coin; (4) exchanges and cash items; (5) balances due from other federal reserve banks,

from member banks and from foreign banks; (6) rediscounts and advances; (7) investments; and (8) miscellaneous assets.

A complete verification of all these resources may be readily effected as follows:

Gold reserves consist of several parts, namely:

First: The gold redemption fund on deposit with the United States treasury to redeem federal reserve notes—this may be verified by confirmation.

Second: Gold on deposit with the federal reserve agent to secure federal reserve notes—this may be verified by inspection and count and by confirmation.

Third: The gold settlement fund, a deposit with the United States treasury to effect settlements with other federal reserve banks—this may be verified by confirmation.

Fourth: Gold bullion, coin and certificates on hand—this may be verified by inspection and count.

Fifth: Gold in custody of the Bank of England—this may be verified by confirmation.

Sixth: Gold at the assay office in process of assay—this may be verified by inspection of gold warrants.

The other assets—which include miscellaneous cash on hand, exchanges and cash items, balances due from other banks, rediscounts and advances and investments—may be verified by the methods commonly used in examinations of commercial banks. There is, however, one important difference. In a federal reserve bank a complete verification of loans and collateral may be effected by obtaining confirmations from every bank in the district, in addition to the inspection, count and proof of notes and securities.

In commercial practice it is theoretically impossible and generally impracticable to effect a complete verification of receivables. It is true that in examinations of commercial banks the confirmation of loans is sometimes attempted and occasionally with satisfactory results, but in other commercial audits it is rare that the client permits confirmation of receivables and rarer still when such procedure achieves the purpose desired. In any case the scope of the confirmation must be confined to the names that appear in the books and may not reveal unrecorded items. Finally, one of the most difficult problems in all examinations and audits—namely, determining whether the receivables are good

assets or not—hardly exists in the audit of a federal reserve bank. The loans are due from national banks and from state banks and trust companies that have met the requirements of membership; a large portion is secured by the highest grade of collateral; the rediscounts bear the names of makers of eligible character and a bank endorsement. The possibility of loss is remote.

Again, the problem of determining the real value of investments as an asset—often a difficult one in commercial practice—does not exist in the examination of a federal reserve bank. The investments held consist only of United States securities.

The methods of verifying surplus and profit and loss, income and expense are the same as those used in the audit of a commercial bank.

EXAMINATION OF SECURITIES HELD IN SAFEKEEPING

The verification of assets and liabilities that has been outlined constitutes the first part of an examination of a federal reserve bank. The second part consists in counting and confirming securities held in safekeeping. Generally speaking these securities belong to member banks, but in some cases federal reserve banks act as custodians of securities for the United States government. The verification consists, first, in ascertaining that the securities on hand are in accordance with the requirements of the bank records and, second, that as shown by confirmations they are in agreement with the records of the depositors or owners.

EXAMINATION OF SECURITIES HELD AS FISCAL AGENT OF THE UNITED STATES

The third part of the examination consists of counting and confirming securities held as fiscal agent of the United States. These consist of three general classes, namely: (1) Liberty bonds and Victory notes belonging to the United States government, held by the bank for exchange of denomination, conversion, registration, exchange of temporary for permanent certificates and exchange of registered for coupon form; (2) United States certificates of indebtedness belonging to the United States held by the bank for distribution, exchange of denomination, etc.; (3) securities pledged by member banks as collateral for United States deposits. The verification of these classes of securities consists in ascertaining, first, that the securities on hand are in accordance with the requirements of the bank records and, second,

Auditing Federal Reserve Banks

that as shown by confirmations they are in accordance with the records of the owners.

EXAMINATION OF THE FEDERAL RESERVE AGENT'S DEPARTMENT

The fourth part of the examination consists of verifying the federal reserve notes, commercial paper and gold in possession of the federal reserve agent. This is accomplished by a physical count. The total of federal reserve notes found is a factor in verifying the amount of such notes outstanding.

This outline covers the important points in the theory which, in my opinion, should govern the examination of a federal reserve bank. Time does not permit a discussion of the many problems that arise in putting this theory into practice. Suffice it to say that the examination described has been successfully accomplished on a number of occasions. For example, in the federal reserve bank of New York two such examinations are made each year. One of these, which took place as of the close of business May 29, 1920, was, I believe, the largest examination ever made, when measured by total resources verified. On that date the total assets of the federal reserve bank of New York amounted to over two billion dollars, and the securities, gold, etc., held in a fiduciary capacity amounted to \$3,600,000,000, approximately, making a grand total of over \$5,600,000,000 subject to examination. Of this total \$1,425,000,000 of Liberty loan bonds and Victory notes held for the United States government were examined at a subsequent date. Thus the total of resources examined as of May 29, 1920, was \$4,175,000,000 which included:

- (1) The assets of the bank \$2,000,000,000
- (2) Securities held in fiduciary capacity . . . 2,175,000,000

\$4,175,000,000

As an indication of the volume of work done a few statistics may be of interest to you.

Gold bullion and coin amounting to approximately \$223,000,000 were inspected and counted.

Currency of all classes approximating \$218,000,000 was verified by physical count.

Bills representing rediscounts and advances and acceptances purchased amounting to over one billion dollars were examined and checked to the records.

Deposits aggregating \$944,000,000 were verified by confirmed reconcilements.

Two similar examinations have since been made, one as of October 29, 1920, in which \$3,760,000,000 of resources were verified, and another as of June 24, 1921, involving the verification of \$4,231,000,000.

Since the cash, notes and securities move very rapidly, careful planning is necessary in order that the operations of the bank may not be impeded.

The plan specified the jobs to be done each day, the order of work, the organization of the force for each day's work including the assignment of each man and other details too numerous to mention. The active cash, the exchanges and cash items, the notes and acceptances must be verified and proved the day of the examination so as to be released the following morning, and also so that the whole force will be immediately available thereafter to begin the examination of securities. Within two days collateral for rediscounts and advances, collateral for government deposits and active securities held in safekeeping, if possible, must be inspected, counted and checked against the records and the records must be proved to the controls, so that the securities can be released. For this work the force is divided into four sections, namely, counting section, checking section, exceptions section and vault section.

The vault section takes the securities from the vault compartments, packs them in trunks, recording the number of packages and the trunk number, and routes the trunks to the counting section. The counting section examines and counts the securities, records the count on work sheets, transmits the work sheets to the checking section and routes the trunks of counted securities back to the vault section. The checking section checks the work sheets against the records and proves the records and the work sheets to the controls. The exceptions crew looks up any differences between the work sheets and the records. While this is going on a small group of stenographers is sending out letters requesting confirmations of loans, securities, etc., and the book-keeping department has already sent out statements of member banks' accounts with reconciliation blanks enclosed. Meanwhile several men are at work proving the remittance accounts. During the following weeks the reserve cash is counted, the inactive securities held in safekeeping are verified, gold bars are inspected,

accounts with other banks are reconciled and the confirmations are checked and proved. Within two months after the date of the examination all confirmations are received and all accounts with other banks are reconciled, excepting a few foreign ones, and then a report is made to the board of directors. This report contains a few exceptions which are subsequently disposed of so that finally it is possible to give an unqualified certificate.

In addition to these balance-sheet examinations there is also a current audit, the purpose of which is to detect errors, exceptions or discrepancies promptly and to dispose of them before the facts get cold. The main operations of the current audit include frequent reconcilements of accounts with other banks, the daily checking of shipments of securities and currency both inward and outward, the daily checking of transactions in government securities, the daily checking of the general ledger entries and the statement of condition and the audit of expenses and of earnings. From time to time, also, examinations are made of certain departments or divisions.

The subject of auditing federal reserve banks is a large one and can be presented only in outline on an occasion of this kind. Numerous details must necessarily be omitted. It is a subject, however, of the utmost importance, since it involves nothing less than the protection of resources that are the foundation of our banking and currency systems. These resources are held by the federal reserve banks in ownership, but in a larger sense they are the resources of the public, the note holders and the commercial banks of the country. They are of the most liquid character and the greater part easily negotiated. They must be rigidly safeguarded. Every necessary and desirable step, every precaution must be taken to this end. In making this effort there is no more important measure to be adopted than that of establishing efficient auditing.