Board of Governors of the Federal Reserve System

REPORT ON THE CONTROL REVIEW OF THE BOARD'S CURRENCY EXPENDITURES AND ASSESSMENTS

OFFICE OF INSPECTOR GENERAL

September 2008

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

OFFICE OF INSPECTOR GENERAL

September 30, 2008

Ms. H. Fay Peters, Director
Management Division
Ms. Louise L. Roseman, Director
Reserve Bank Operations and Payment Systems
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Ms. Peters and Ms. Roseman:

The Office of Inspector General (OIG) of the Board of Governors of the Federal Reserve System (Board) is pleased to present its *Report on the Control Review of the Board's Currency Expenditures and Assessments*. Currency expenses are the largest line item on the Board's annual financial statements, totaling approximately $576 million in 2007. This figure appears twice on the financial statements—as an expense for printing, transporting and retiring Federal Reserve notes, and as an assessment levied on the Reserve Banks for the cost of currency—with a zero net effect on the Board's reported results of operations. Because these currency costs are levied on the Reserve Banks and also appear on their financial statements, a sound control environment is important to ensure that the costs and processes associated with the currency function are accurate, fully supported, and in compliance with applicable laws and regulations.

Our objective was to evaluate the effectiveness of the Board's controls over processes to record currency expenses and to levy assessments on the Reserve Banks for these expenses. More specifically, we assessed whether the controls over these transactions are designed and operate effectively to provide reasonable assurance that (i) records and transactions are maintained in sufficient and accurate detail to permit the preparation of the Board's financial statement information in accordance with generally accepted accounting principles; (ii) financial transactions are processed in compliance with applicable laws, regulations, and management's authorization; and (iii) unauthorized or fraudulent transactions are prevented or can be detected in a timely manner. As part of our review, we developed detailed flowcharts and narratives of the Board's expenditure and assessment processes for each currency expense, including the Board's interaction with the Bureau of Engraving and Printing (BEP) for currency production and billing. We used the flowcharts to identify controls, and tested certain controls by tracing currency-related transactions through the Board's expenditure and assessment processes.

Overall, we found that the Board has controls over the processes to record currency expenses and to levy assessments on the Reserve Banks for these expenses, and that the majority of the controls were operating effectively. We did not detect any instances of fraud or other improprieties. Although our testing did not identify any significant discrepancies, we did find opportunities to strengthen the Board's controls for paying currency invoices, preparing and processing assessments, monitoring vendor performance, and reporting the currency expenses in the Board's financial statements. In addition, fully implementing certain automated controls in the Board's financial management system would improve controls and reduce manual processing. Finally, while we found that the Board has a good working relationship with BEP and has established compensating controls and processes related to printing expenses, we believe that the Board should strengthen the current inter-agency agreement with BEP by formalizing existing operational reviews and enhancing inventory controls. Our report contains six recommendations designed to address these issues.

We provided a copy of our report to you for review and comment. In your response, included as appendix 1, you indicated agreement with the report recommendations and discussed actions already underway or that will be taken to implement the recommendations.

The principal contributors to this report are listed in appendix 2. We are providing copies of this report to Board management officials. The report will be added to our public web site and will be summarized in our next semiannual report to the Congress. Please contact me if you would like to discuss the report or any related issues.

Sincerely,

/signed/

Elizabeth A. Coleman
Inspector General

Enclosure

cc: Vice Chairman Donald L. Kohn
Governor Kevin M. Warsh
Mr. Stephen R. Malphrus
Mr. Donald Spicer
Mr. William Mitchell
Mr. Jeffrey Marquardt
Mr. Donald Hammond
Mr. Michael Lambert
Mr. Gregory Evans

Board of Governors of the Federal Reserve System

REPORT ON THE CONTROL REVIEW OF THE BOARD'S CURRENCY EXPENDITURES AND ASSESSMENTS

OFFICE OF INSPECTOR GENERAL

September 2008

TABLE OF CONTENTS

Page

BACKGROUND

The Federal Reserve Act (Act) establishes broad authorities and responsibilities related to the production, distribution, and destruction of Federal Reserve notes.[1] For example, the Act authorizes the Board of Governors of the Federal Reserve System (Board) to issue notes at its discretion and provides that such notes are obligations of the United States. The Act also assigns responsibility for the production of Federal Reserve notes to the Secretary of the Treasury, and provides the Secretary with the authority to prescribe procedures for the cancellation and destruction of notes that are unfit for circulation. The Secretary has, in turn, delegated production authority to the Bureau of Engraving and Printing (BEP).[2] The Act also authorizes the Board to levy an assessment on the Federal Reserve Banks to pay for all expenses related to producing, issuing, and retiring Federal Reserve notes.[3]

As part of its currency-related responsibilities, the Board prepares and submits to BEP an annual order for new currency production. Based on the currency order, BEP establishes billing rates for each denomination, and then bills the Board based upon the actual monthly production. During 2006, the Board ordered, and BEP printed, over 8.5 billion notes at a cost of approximately $470 million. In 2007, BEP printed 8.7 billion notes at a cost of about $555 million. The Board also contracts with commercial armored carriers to deliver new currency from BEP to the Federal Reserve Banks and branches, and to ship new and fit currency between the Federal Reserve Banks and branches. In addition, the Board reimburses BEP for costs associated with (1) evaluating each Reserve Bank's compliance with the Department of the Treasury's currency destruction standards and (2) processing claims for the redemption of damaged or mutilated currency. The Board also participates in international consortiums for research and development (R&D) activities related to counterfeit deterrence as well as new currency development.

Although the Act authorizes the Board to levy an assessment on the Reserve Banks for all currency-related expenses, it does not specify either the timing of the assessment or the method to be used for allocating the costs among the twelve Banks. The Financial Accounting Manual for Federal Reserve Banks (FAM) provides that the Board levies the Reserve Banks monthly for printing expenses, and quarterly for expenses associated with shipping and destruction. The FAM also states that the allocation is based on each Reserve Bank's percentage of the net number of notes outstanding on December 31 of the previous year. In 2006, the Board assessed the Reserve Banks approximately $492 million for currency-related expenses incurred during the year; this amount includes expenses for printing, shipping, destruction, and R&D. In 2007, the Board assessed the Reserve Banks about $576 million. Table 1 shows the breakdown of expenses for this two-year period, as well as the frequency of Reserve Bank assessments for each category of expense.

---

[1] Federal Reserve Act, sections 10, 11, and 16 (12 U.S.C. §§ 241, 248(d), and 411, respectively).

[2] Treasury Order 101-07 delegates this authority pursuant to 31 U.S.C § 321(b)(2).

[3] For the purposes of this report, "currency" is synonymous with Federal Reserve notes. The term excludes coins and other monetary instruments.

Table 1 – Currency Expenses and Reserve Bank Assessments

Expense Category	Expense / Assessment Amount		Assessment Frequency
	2006	2007	
	(millions)	(millions)	
Printing	$ 469.7	$ 555.1	Monthly
Shipping	$ 15.1	$ 13.7	Quarterly
Destruction	$ 3.8	$ 4.0	Quarterly
Counterfeit Deterrence R&D	$ 3.3	$ 3.5	Quarterly[1]
Totals	$ 491.9	$ 576.3	

[1] The Board received three invoices in 2006 related to R&D expenses. The assessment for these expenses is combined with the respective quarterly shipping assessment.

Within the Board, the Division of Reserve Bank Operations and Payment Systems (RBOPS) is responsible for developing the new currency print order, coordinating shipments of currency from BEP to the Reserve Banks and between the Reserve Banks and branches, preparing the annual new currency budget, and collaborating with government agencies regarding counterfeit deterrence activities. RBOPS and BEP staff use a Board-developed automated system, the Currency Ordering System (COS), to monitor and control the production, inventory, and distribution of new currency throughout the United States. RBOPS also uses two COS subsystems: Carrier Billing Online (CBO) and Special Shipments. CBO is designed to streamline and automate the billing process between the Board and armored carrier companies. Special Shipments tracks currency shipments that are transported between one Federal Reserve Bank and another. The Board's Management Division (MGT) has responsibility for paying currency expenses, preparing the corresponding assessments, and levying the assessments on the Reserve Banks. MGT staff pays BEP for printing and destruction expenses after the Reserve Banks are assessed; shipping and R&D expenses are paid prior to levying the assessments. MGT staff calculate each Bank's share for a given assessment using information provided by RBOPS. The Banks' payments are deposited into the Board's general fund account at the Federal Reserve Bank of Richmond (FRB Richmond); the Board's expenses are paid from this account. MGT also has overall responsibility for the Board's procurement function, including procurement of the currency armored carrier services.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objective was to evaluate the effectiveness of the Board's controls over processes to record currency expenses and to levy assessments on the Reserve Banks for these expenses. More specifically, we assessed whether the controls over these transactions are designed and operate effectively to provide reasonable assurance that (i) records and transactions are maintained in sufficient and accurate detail to permit the preparation of the Board's financial statement information in accordance with generally accepted accounting principles; (ii) financial transactions are processed in compliance with applicable laws, regulations, and management's authorization; and (iii) unauthorized or fraudulent transactions are prevented or can be detected in a timely manner. To accomplish our objective, we reviewed relevant documentation, analyzed accounting records, and interviewed MGT and RBOPS staff. We also met with automation support staff in the Board's Division of Information Technology to better understand the functionality within COS.

We did not, however, specifically evaluate COS automated controls as part of this review. The OIG recently conducted a separate security control review of COS and its two subsystems as part of our legislated responsibilities under the Federal Information Security Management Act (FISMA).[4] We also interviewed FRB Richmond staff responsible for processing the Reserve Banks' assessment payments. In addition, we met with BEP financial management and production personnel to further understand the Bureau's currency operations and related costs, as well as the information flows between the Board and BEP. We did not specifically evaluate BEP's processes or controls.

Based on discussions and applicable documentation, we developed detailed flowcharts and narratives of the Board's expenditure and assessment processes for each currency expense category. We used the flowcharts to identify controls, including key controls, for testing during fieldwork. To test selected controls, we traced the currency-related transactions through the Board's payment and assessment processes. We confirmed invoice amounts, assessment totals, and allocations; reviewed the associated documents for proper approvals; and analyzed accounting reports. For currency costs associated with printing, destruction, and R&D, we reviewed all nineteen payments made during calendar year 2006, as well as the corresponding assessments. For currency shipping, we evaluated a judgmental sample of twenty-four carrier invoices processed during the first six months of 2007 and the two related quarterly assessments. We focused on calendar year 2007 transactions for this category of expenses because the Board implemented a major enhancement to CBO in late 2006; the enhancement automated the invoicing process for carrier-related costs. In addition, we reviewed the currency carrier contracts and evaluated the contract awards for compliance with the Board's procurement procedures. Our review, which was conducted between April 2007 and May 2008, was performed in accordance with generally accepted government auditing standards.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

Overall, we found that the Board has controls over the processes to record currency expenses and to levy assessments on the Reserve Banks, and that the majority of the controls were operating effectively. Our testing did not identify any significant discrepancies, the supporting documentation we reviewed was sufficient to permit the proper preparation of the Board's financial statements, and nothing came to our attention to indicate any instances of fraud or non-compliance with laws and regulations. In our opinion, staff involved with ordering currency,

[4] Our restricted report on the *Control Review of the Currency Ordering System* was issued in June 2008.

scheduling shipments, and coordinating efforts with BEP are dedicated employees who collectively possess considerable institutional knowledge. Staffs' commitment to these processes is, we believe, one reason why our testing did not identify significant deficiencies.

Our fieldwork did, however, identify opportunities to enhance the Board's processes and strengthen controls for paying currency invoices, preparing and processing assessments, monitoring vendor performance, and reporting the currency expenses in the Board's financial statements. Specifically, we found that MGT processed invoices approved by RBOPS staff working in the currency section who were not listed on delegation of authority forms. In addition, MGT supervisors did not always review assessment allocations before levying the Reserve Banks, and the Board did not sufficiently monitor the currency carriers' contracts to ensure that current insurance certificates were on file. We also found that the Board's financial statements contain section headings, line descriptions, and footnotes that do not, in our opinion, adequately describe currency costs. Our first four recommendations are directed at strengthening these controls and improving these processes.

Our fieldwork also identified opportunities to strengthen the automation environment related to currency assessments. We found that MGT had not enabled certain automated controls in the Board's financial management system, resulting in additional manual processes to calculate the Reserve Bank assessment amounts. Our report contains one recommendation to address this concern. In addition, as part out our legislated responsibilities pursuant to FISMA, the OIG recently completed a security control review of COS and its two subsystems. Although the FISMA review focused on system controls from an information security perspective, our observations regarding COS account management and configuration change control are also important to the overall control environment for generating and verifying currency expenses. The Board should take into account these recommendations as it implements the other control enhancements contained in this report.

We also found that the Board's processes related to printing expenses place considerable reliance on the controls at BEP. Specifically, BEP staff enter currency data into COS, perform daily reconciliations between COS and BEP systems, and conduct periodic inventories of unissued notes.[5] Although the Board does not formally oversee BEP operations or its internal controls, we found that the Board has established several compensating controls and processes. For example, Board staff monitor currency production against budget information and production schedules, and staff receive copies of the daily reconciliations and the year-end inventory results. Board staff have also conducted operations reviews at BEP's invitation. Although these processes provide a good set of detective controls, we believe the Board should strengthen its current relationship with BEP by formalizing the operations review process and establishing requirements for an independent inventory of unissued notes. The last recommendation in our report addresses this topic.

Ensuring that sufficient currency is in circulation to meet the public's demand is an important responsibility of the Federal Reserve System, and the expenses associated with this function represent the largest line item on the Board's financial statements. Because the costs are

[5] Unissued notes are Federal Reserve notes stored at BEP that are available for shipment to a Reserve Bank or branch.

ultimately paid by the twelve Reserve Banks and, therefore, also appear on their financial statements, the entire System has a vested interest in the Board maintaining a strong control environment to ensure that the costs associated with the currency function are accurate, fully supported, and in compliance with applicable laws and regulations. Our six recommendations are designed to help the Board maintain an effective system of internal controls. During our fieldwork, we also identified lesser control and process enhancements which we plan to communicate separately to the directors of RBOPS and MGT.

1. We recommend that the Director of MGT ensure that currency invoices received for payment are approved by individuals listed on current Delegation of Authority forms.

MGT staff obtain Delegation of Authority (DoA) forms from all Board divisions and offices. These forms identify individuals authorized to approve various types of payments. The DoA form includes the individual staff member's signature and is approved by the responsible division director. MGT staff should verify that invoices have been properly approved prior to payment by comparing signatures on the invoice to the DoA forms.

As part of our testing, we requested the DoA forms for RBOPS that were in effect during our review period to verify that currency invoices were appropriately approved. DoA forms prior to June 2006 could not be located by MGT staff and, therefore, we could not verify invoice approvals for the first five months of 2006. Based on DoA forms that were available, we found that between June and November 2006, MGT staff paid five printing invoices and two destruction invoices that had been approved by RBOPS staff who were not listed on the DoA form. In November 2006, RBOPS prepared an updated DoA form, and we confirmed that all remaining invoices were appropriately approved.

We recognize that the seven invoices we questioned were for valid transactions, and that the RBOPS staff who signed these invoices were knowledgeable about the transaction details. However, we believe that MGT staff should process invoices only after confirming that the approver is listed on the DoA form, and that the invoice approval matches the signature found on the DoA. Ensuring that transactions are properly authorized is a fundamental requirement of an effective system of internal controls. We note that this requirement was added to MGT's procedures related to accounts payable processing as of September 2007. If an invoice presented for payment does not have an appropriate approval, MGT staff should suspend payment until the transaction is properly authorized or a revised DoA form is received.

2. We recommend that the Director of MGT ensure that currency assessment allocations are properly approved.

MGT staff prepare Reserve Bank assessments for currency-related expenses by determining the amount to assess and then allocating this amount across the twelve districts. The Board allocates currency expenses based on each Reserve Banks' share of net notes outstanding as of December 31 of the prior year. MGT staff stated that once the assessment calculation is complete, they will prepare an assessment allocation schedule and forward it to a MGT supervisor for review and approval prior to levying the Reserve Banks.

As part of our fieldwork, we reviewed twenty assessment allocation schedules for accurate calculations and appropriate approvals. Our testing did not identify any incorrect calculations. We found, however, that only one of the twenty assessment schedules had evidence of supervisory approval. When we brought this to their attention, MGT staff noted that the assessment schedules usually receive a supervisor's "cursory review" before the assessment is processed, but that this review may not always be documented. In addition, staff stated that the assessment schedule may bypass the review and approval process because of time constraints.

We consider the review and approval of the assessment allocation schedule to be a key control, as the risk of inaccurate assessments increases if this step is bypassed. We note that MGT's currency-related accounting procedures, approved in January 2008, also identify this process as a key control. In addition, during the 2007 financial statement audit, the Board's external auditors observed that assessment schedule approvals were not consistently documented.

3. We recommend that the Director of RBOPS coordinate with MGT to ensure that currency carriers maintain insurance coverage throughout the length of the contract.

The Board uses commercial carriers for shipping currency throughout the Federal Reserve System. The Board currently has two-year contracts with five commercial carriers; the performance period for each contract is from January 2007 to December 2008. As part of the procurement process, carriers must submit insurance certificates with their proposal. The purpose of the insurance is to protect the Board from the risk of loss or damage to currency while it is in transport. The contracts also require the carriers to maintain insurance coverage throughout the two-year performance period. RBOPS staff serve as the contracting officer's technical representative (COTR), ensuring that the carriers comply with the contract's technical requirements.

During our review of the procurement process for these contracts, we confirmed that all five carriers submitted insurance certificates prior to contract award. However, we found that the insurance certificates submitted by four of the five carriers did not cover the entire length of the two-year contract. The four insurance certificates all expired during 2007, and we did not find additional documentation in the contract file to show that the Board obtained updated insurance certificates. The COTR and MGT staff (who have overall responsibility for the Board's procurement process) stated that they did not monitor the carrier contracts to ensure that updated certificates were obtained after the contracts were awarded.

Without up-to-date insurance certificates, the Board has no assurance that its interests are adequately protected or that carriers are adhering to the terms of the contract requiring this insurance. A lapse in insurance coverage poses a potential monetary risk to the Board given the dollar value involved in currency shipments, as well as a reputational risk to the Board, should an incident occur. When we brought this concern to their attention, MGT staff took prompt action to obtain updated certificates. We reviewed these new certificates and found no indication that coverage had lapsed for any of the carriers. Since two of the four updated certificates expire prior to the end of the current contract period, we believe that RBOPS staff, as the COTR, should coordinate with MGT staff (who maintain all contractual-related documents) to monitor the carrier contracts and ensure that up-to-date insurance certificates are always on file.

4. We recommend that the Director of MGT enhance the Board's financial statements by expanding the description of, and providing supplemental information on, currency expenses and assessments.

Currency expenses and assessments are the largest line items reported on the Board's financial statements. These costs include printing, shipping, destruction, and R&D expenses. Our review did not identify any discrepancies in the amounts reported for these expenses in the Board's financial statements. However, our review found that the line item descriptions and corresponding footnotes do not adequately explain the expenses, assessments, and associated transactions. As stated in industry guidance, financial statements should include sufficient explanations and interpretations to help users understand the financial information provided.

We found, for example, that the Board's financial statements listed the currency assessments and expenses under the heading "Issuance and Redemption of Federal Reserve Notes." Although the terminology "issuance and redemption" parallels language found in the Federal Reserve Act, the heading is not descriptive of any of the four categories of expenses. The heading also fails to refer to the Reserve Bank assessments, even though it is one of the two line items underneath the heading. We note that in the 2007 financial statements the heading was changed to "Currency Costs." While the new heading more broadly describes the expenses, it still fails to refer to the assessments. We also found that the financial statements describe the line item for currency expenses as "Printing, issuance, retirement, and shipping." This description fails to mention the R&D expenses. We believe that modifying the currency heading and line descriptions would help clarify the information contained in the financial statements.

We also believe that the footnote disclosures related to currency can be enhanced. For example, the financial statements do not discuss the Board's working relationship with BEP. The Board is statutorily obligated to order currency from BEP and to reimburse BEP for the cost of production; more than 95 percent of the total currency expenses are paid to BEP for printing. We note that BEP acknowledges this relationship in their annual financial statements, as the Board is BEP's largest customer. In our opinion, incorporating the roles and responsibilities of the two entities into the Board's financial statement footnotes would provide a better understanding of the relationship between BEP and the Board.

In addition, we believe that the footnotes should provide a breakout of the four components of currency expenses (printing, shipping, destruction, and R&D) as well as a brief description of each expense. The Board already issues an annual budget report that includes an appendix that discusses the currency budget and describes each expense category in detail. We believe that including some of this information in the financial statement footnotes or, at a minimum, including a reference to the budget report, would provide the reader with a more thorough description and better understanding of currency related expenses. The Board could also expand the footnotes to explain that the reported expenses do not include other costs associated with currency incurred directly by the Reserve Banks, such as the districts' currency-processing equipment and associated staffing costs. An expanded disclosure would better inform the reader about the factors that comprise the currency line item in the Board's financial statements.

5. We recommend that the Director of MGT implement additional controls in the Board's financial management system to restrict currency account codes to the currency cost center.

The Board's financial management system maintains and processes financial data and transactions, including currency-related expense and assessment transactions. Within this system, cost centers and account codes are used to classify and record transactions. Cost centers track a group of transactions for a specific business unit or functional purpose; account codes identify financial transactions by type, such as assets, liabilities, revenues or expenses. The Board uses one cost center to accumulate all currency-related transactions. The Board also uses five currency account codes to track currency-specific revenue and expense transactions.

During our fieldwork, MGT staff explained that they perform multiple manual steps to ensure accurate quarterly assessments for shipping and R&D expenses. Specifically, a staff member first analyzes a report listing all expense account codes for the currency cost center. Another individual—using a summary trial balance report which lists totals by account code regardless of the cost center—then independently calculates the shipping and R&D expenses. Finally, a supervisor compares the two amounts for each expense to confirm that no miscoded transactions exist in either report. MGT then assesses the Reserve Banks for these expense categories based on the reconciled amounts.[6]

We found that the Board's financial management system has the capability to restrict specific account codes to a given cost center. This feature, referred to as cross-validation, helps prevent miscoded transactions, and would eliminate the additional manual steps that MGT staff presently perform to reconcile expense totals. Although the Board has implemented this functionality for certain cost centers and account codes, we confirmed that MGT had not implemented cross-validation rules to restrict currency account codes to the currency cost center at the time of our review. Although we did not find any mathematical errors in the assessment we reviewed, we believe that MGT should implement the financial management system's cross-validation rules for currency transactions. Implementing this feature will, in our opinion, strengthen controls and increase efficiency.

6. We recommend that the Director of RBOPS establish agreements between the Board and BEP to 1) formalize the vault operational reviews and 2) develop a mechanism to independently verify the unissued notes inventory.

The Act and other federal statutes set broad responsibilities regarding the issuance and retirement of Federal Reserve notes. The Board and BEP have also developed a memorandum of understanding (MOU) that further describes each organization's authorities and responsibilities related to currency printing, shipping, and destruction. For example, the MOU prescribes that the Board is responsible for establishing the annual print order and for notifying BEP of planned currency shipments to the Reserve Banks and branches. BEP, in addition to printing currency, is responsible for storing notes in a secure environment until shipped; for auditing and verifying the

[6] MGT staff do not perform a similar reconciliation for printing and destruction expenses. Printing expenses are assessed each month based on the monthly BEP invoice before the invoice is paid. Destruction expenses are assessed each quarter based on the quarterly BEP invoice before the invoice is paid.

unissued note inventory; and for prescribing procedures to cancel, destroy, and account for unfit currency. The two entities are supposed to jointly verify the monthly total of notes produced by BEP and the cost of those notes. The MOU was last updated in 1998.

Neither the statutes nor the MOU provide for any direct oversight of BEP by the Board for currency production or operations. We found, however, that RBOPS staff have periodically performed BEP vault operational reviews at the invitation of BEP management. RBOPS conducted its most recent review in 2006. The review's objectives included an assessment of BEP's internal controls over the Federal Reserve vault operations and public sales program, including an evaluation of the adequacy of and compliance with vault procedures, as well as an assessment of BEP's monthly reporting and invoicing of unissued notes. While the review identified a number of concerns, RBOPS did not perform any specific follow-up work on these findings; staff stated that operational improvements were noted during regular contact with BEP.

Absent specific statutory authority, we believe that the operational reviews are in keeping with the Board's general authority to "…supervise and regulate through the Secretary of Treasury the issue and retirement of Federal Reserve notes."[7] The Board and BEP maintain a unique "customer-vendor" relationship and rely on the close working relationship between the two entities to coordinate currency printing and shipping. We believe that the Board should work with BEP to formalize the operational reviews and establish a regular frequency for conducting the reviews; RBOPS staff told us that the last review prior to 2006 was conducted in 2001. We also believe that the review's agreement should provide for the Board to follow-up on concerns or suggestions identified, as appropriate. These provisions will establish a more proactive method to identify issues before problems arise and provide assurance that concerns have been addressed. We note that the Board and BEP staff are currently reviewing the existing MOU, and that these provisions could be added to that agreement.

We also believe that controls over the inventory of unissued notes could be strengthened. We found that BEP's Office of Compliance, an operating unit separate from BEP's currency production environment, performs a daily reconciliation between an internal BEP system and the Board's COS. The Office also conducts quarterly inventories of unissued notes. Results of these activities are communicated to the Board as prescribed in the MOU. However, a routine, independent inventory of unissued currency is not currently performed. BEP's external auditors, for example, do not review the unissued inventory as part of the Bureau's annual financial statement audits, and we were unable to identify any non-BEP entity performing this function.

While the Office of Compliance is independent of the BEP production function, we believe that an independent third party should perform a periodic inventory of unissued notes to supplement the inventories and reconciliations performed by BEP staff. In our opinion, an independent inventory is a fundamental control that provides for an appropriate separation of responsibilities. Allowing for an independent inventory at the Board's request is another requirement that should be added to the existing MOU.

[7] Federal Reserve Act, section 11(d) 12 U.S.C. § 248(d)

ANALYSIS OF COMMENTS

We provided a copy of this report to the director of MGT and the director of RBOPS for review and comment. In their response, included as Appendix 1 to this report, the directors agreed with the report recommendations and discuss actions already underway or that will be taken to implement the recommendations. Specifically, the director of MGT plans to automate the verification of invoice approvals by tracking and routing approvals online in the financial management system. The director also has implemented functionality in this system to require the review and approval of the assessment allocation online, as well as restricting currency account codes to the currency cost center. The director's response states that presentation refinements in the 2008 financial statements will include additional explanations and interpretations of currency-related information. The director of RBOPS plans to ensure that currency carriers' insurance certificates are kept current and comply with the contractual requirements. In addition, RBOPS staff will begin discussions with BEP on updating the MOU to provide for periodic reviews of BEP vault operations, and include a mechanism for an independent third-party verification of the unissued notes inventory.

APPENDIXES

Appendix 1 ─ Division Directors' Comments

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

September 12, 2008

Ms. Elizabeth Coleman
Inspector General
Office of the Inspector General
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Beth:

Thank you for the opportunity to review and comment on the draft *Report on the Control Review of the Board's Currency Expenditures and Assessment* dated August 29, 2008. We are pleased that the review did not detect any instances of fraud or other improprieties and that the majority of the controls over the processes to record currency expenses and to levy assessments on the Reserve Banks for these expenses are operating effectively. As discussed below, we agree with your recommendations and have either implemented or plan to implement actions to address them.

Recommendation 1: We recommend that the Director of MGT ensure that currency invoices received for payment are approved by individuals listed on current Delegation of Authority forms.

Response: We concur with this recommendation. Verifying signatures on invoices against a Delegation of Authority form is one of the steps in the "AP Invoice Processing" procedures, and MGT staff has been reminded of the importance of verifying authorizations prior to payment. As noted in the report, we addressed this issue in November 2006, and RBOPS will ensure going forward that the DoA forms remain up to date.

The MGT division also plans to implement online approval for invoices, which will allow it to use the financial system's functionality to route invoices directly to the individuals who have been authorized to approve payment. Actions taken on invoices will automatically be tracked within the system.

Recommendation 2: We recommend that the Director of MGT ensure that currency assessment allocations are properly approved.

Response: We concur with this recommendation. As the report notes, review and approval of the assessment allocation schedule is a key control in the division's currency-related accounting procedures. The MGT division now uses functionality in the financial system to restrict the data entry and approval responsibilities, and the AR/AP supervisor reviews and approves the assessment allocation online. As part of the approval process, the supervisor also recalculates the allocation to help ensure accuracy.

Recommendation 3: We recommend that the Director of RBOPS coordinate with MGT to ensure that currency carriers maintain insurance coverage throughout the length of the contract.

Response: We concur with this recommendation. MGT staff will obtain current insurance certificates as the certificates expire, and RBOPS staff will work with the Procurement staff to request these certificates. MGT and RBOPS staff will review the certificates to ensure that the carriers' insurance coverage is current and complies with the contract requirements.

Recommendation 4: We recommend that the Director of MGT enhance the Board's financial statements by expanding the description of, and providing supplemental information on, currency expenses and assessments.

Response: We concur with this recommendation. As the report notes, the MGT division implemented several changes in the 2007 financial statements, and it will refine the presentation in the 2008 statements to include additional explanations and interpretations of the currency-related information. MGT staff will work with RBOPS staff to draft the additional language.

Recommendation 5: We recommend that the Director of MGT implement additional controls in the Board's financial management system to restrict currency account codes to the currency cost center.

Response: We concur with this recommendation. The MGT division implemented this change earlier this year. Consistent with our discussions at the closing meeting, MGT staff will also review the possibility of assessing all expenses on a monthly basis, which will further streamline the account reconciliation process.

Recommendation 6: We recommend that the Director of RBOPS establish agreements between the Board and BEP to 1) formalize the vault operational reviews and 2) develop a mechanism to independently verify the unissued notes inventory.

Response: We concur with this recommendation. RBOPS staff will begin working with the BEP within the next month to update the Board-BEP memorandum of understanding (MOU). RBOPS will recommend that the MOU provide for periodic reviews of the BEP vault operations by RBOPS staff to assess efficiency and the control environment.

Additionally, RBOPS staff will begin discussions with the BEP to include in the MOU a mechanism for an independent third-party verification of the unissued notes inventory. This verification would be in addition to the existing verification performed by the BEP's Office of Compliance.

Appendix 1 ─ Division Directors' Comments

We appreciate the constructive feedback provided by the review team. If you have any questions regarding our remediation efforts, please let us know.

Sincerely,

/signed/

H. Fay Peters
Director, Management Division

/signed/

Louise L. Roseman
Director, Division of Reserve Bank Operations and Payment Systems

cc: Stephen Malphrus
Don Spicer
Bill Mitchell
Jeffrey Marquardt
Don Hammond
Gregory L. Evans
Michael Lambert
Brenda Richards
Cynthia Gray

Appendix 2 – Principal Contributors to this Report

Timothy Rogers, Auditor and Auditor-in-Charge

Chie Hogenmiller, Auditor

Keisha Turner, Auditor

Jacqueline Becker, Senior Counsel

Cynthia Gray, Project Manager

Andrew Patchan, Jr., Assistant Inspector General for Audits and Attestations