

Board of Governors of the Federal Reserve System

The Board Can Further Enhance the Design and Implementation of Its Operating Budget Process



Office of Inspector General
Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection



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Executive Summary, 2020-FMIC-B-010, March 25, 2020

The Board Can Further Enhance the Design and Implementation of Its Operating Budget Process

Findings

The Board of Governors of the Federal Reserve System designed and implemented processes to formulate and execute its annual operating budget. The Board has made changes over the past several years to improve its budget process; the Board has acknowledged perennial underspending and is addressing it by focusing on slowing growth and spending more consistently with budget estimates. The Board can further enhance the design and implementation of its operating budget process by communicating its budget process in an overarching document, strengthening the connection between budget and strategy, and implementing a Boardwide approach to executing the approved budget.

Enhancing the Board's operating budget process may help the Board (1) define a more predictable and repeatable process; (2) prioritize funding and monitor progress against strategic goals; and (3) allocate financial and human capital resources more effectively, including conducting tradeoffs across the agency.

Recommendations

Our report contains recommendations designed to help the Board enhance the design and implementation of its operating budget process. In its response to our draft report, the Board concurs with our recommendations and outlines actions that have been or will be taken to address each recommendation. We will follow up to ensure that the recommendations are fully addressed.

Purpose

We conducted this evaluation to assess the design and implementation of the Board's processes for formulating and executing its annual operating budget. The scope of our evaluation was 2018 budget activities, which included executing the Board's 2018 budget and formulating the Board's 2019 budget.

Background

We use the term *operating budget* to refer to allocating financial and human capital resources to perform an organization's day-to-day operations. Leading practices indicate that an organization should develop its operating budget based on organizational priorities and should monitor and adjust the budget to reflect changing conditions.

Although the Board is not subject to federal budget-related laws, such as the Government Performance and Results Act of 1993, as amended by the GPRA Modernization Act of 2010, it prepares an annual budget as part of its efforts to ensure appropriate stewardship and accountability. The Board's 2018 annual operating budget was \$766.7 million and included 2,847 authorized positions.



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Recommendations, 2020-FMIC-B-010, March 25, 2020

The Board Can Further Enhance the Design and Implementation of Its Operating Budget Process

Finding 1: DFM Can Enhance the Design of Its Annual Operating Budget Process

Number	Recommendation	Responsible office
1	Finalize and communicate the budget process, including the connection among strategy, budget, and performance, in an overarching document, and consider implementing additional methods or tools to reinforce DFM's expectations to the divisions.	Division of Financial Management

Finding 2: DFM Can Better Implement Its Annual Operating Budget Process

Number	Recommendation	Responsible office
2	Identify, develop, and implement methods to more effectively execute the Board's budget on the enterprise level. In doing so, the CFO and the COO should consider the delegated authorities, organizational structures, and policies available to make prioritization decisions. The CFO and the COO should also consider other techniques to transition toward an enterprise view of the budget, including accountability measures for division resource management.	Division of Financial Management and the Office of the Chief Operating Officer, in coordination with the administrative governor



Office of Inspector General

Board of Governors of the Federal Reserve System
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MEMORANDUM

DATE: March 25, 2020

TO: Patrick J. McClanahan
Chief Operating Officer
Board of Governors of the Federal Reserve System

Ricardo A. Aguilera
Chief Financial Officer
Board of Governors of the Federal Reserve System

FROM: Michael VanHuysen 
Assistant Inspector General for Audits and Evaluations

SUBJECT: OIG Report 2020-FMIC-B-010: *The Board Can Further Enhance the Design and Implementation of Its Operating Budget Process*

We have completed our report on the subject evaluation. We conducted this evaluation to assess the design and implementation of the Board's processes for formulating and executing its annual operating budget.

We provided you with a draft of our report for review and comment. In the Division of Financial Management's (DFM) response, you concur with our recommendations and outline actions that have been or will be taken to address our recommendations. We have included DFM's response as appendix B to our report.

We appreciate the cooperation we received from your staff during our evaluation. Please contact me if you would like to discuss this report or any related issues.

cc: Steve Bernard
Karen Vassallo
William Futrell
Cheryl Patterson



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Introduction

Objective

Since 2014, we have noted in our annual major management challenges reports that the Board of Governors of the Federal Reserve System’s complex governance system creates challenges for the Board to use an enterprisewide approach for managing certain administrative functions. In a 2017 evaluation report, we noted that the Board had implemented certain changes to improve its budget process, including setting expectations early in the budget cycle for the target growth rate and grouping divisions into functional areas. However, division directors and Board officials noted that challenges with budget formulation and execution continued.¹

The objective of this evaluation was to assess the design and implementation of the Board’s processes for formulating and executing its annual operating budget. We use the term *operating budget* (or simply, *budget*) to refer to allocating financial and human capital resources to perform an organization’s day-to-day operations. We focused on governance over the budget process, including budget policies, procedures, or guidance; delegations of authority; organizational structures; and communication. We also focused on the strategic plan connection, divisions’ budget representative (budget contact) preparedness and training, and position management. The scope of our evaluation was 2018 budget activities, which included executing the Board’s 2018 budget and formulating the 2019 budget. The Board’s 2018 annual operating budget was \$766.7 million and included 2,847 authorized positions.

To address our objective, we reviewed applicable laws, regulations, and Board documents; interviewed representatives from 14 Board divisions; analyzed budget data; and benchmarked with four organizations (three other nonappropriated agencies and one financial institution).² Details on our scope and methodology are in appendix A.

Background

The Board’s Operating Budget

Leading practices indicate that an operating budget should be informed by an organization’s strategic objectives; an organization should develop its budget based on organizational priorities and should monitor and adjust the budget to reflect changing conditions. Leading practices also suggest that budgeting is a key source of information for organizations; it can help an organization make and assess the effect of its decisions, execute on its strategy, and control its spending.

¹ Office of Inspector General, *The Board’s Organizational Governance System Can Be Strengthened*, [OIG Report 2017-FMIC-B-020](#), December 11, 2017.

² To maintain our independence, we excluded the Office of Inspector General from this evaluation.

The Federal Reserve Act provides the Board certain powers related to finance and employment.³ It authorizes the Board to assess the Federal Reserve Banks an amount sufficient to pay its estimated expenses and allows the Board to determine how it will spend those funds. Given the Board's budgetary independence, it is not subject to federal budget-related laws, such as the Government Performance and Results Act of 1993, as amended by the GPRA Modernization Act of 2010 (GPRA).⁴ Nonetheless, the Board states in its *105th Annual Report* that it prepares an annual budget as part of its efforts to ensure appropriate stewardship and accountability.⁵ The Board also follows the spirit of GPRA, and similar to other federal agencies, it publishes a strategic plan, an annual performance plan, and an annual performance report.

Governance of the Board's Operating Budget

Budgetary Activity Authorities

In accordance with the Federal Reserve Act, the Board can delegate management and administration to Board employees. The Board has delegated administrative authority to execute its internal administrative functions, including the budget, through the following delegation of administrative authority documents:

- *Delegations from the Board to the Chair and the Inspector General*
- *Chairman's Delegations of Administrative Authority*
- *Administrative Governor's Delegations of Administrative Authority*
- *Chief Operating Officer's Delegations of Administrative Authority*

Specifically, the Board delegates to the chair, and the chair redelegates to the administrative governor, the responsibility and authority for the overall internal management and organization of the Board's resources to ensure the effective performance of all Board functions. This delegation includes management policies for financial planning and the review and presentation of the operating budget to the Board. The administrative governor also chairs the standing Committee on Board Affairs (CBA), which is responsible for overseeing and executing the Board's planning and budget process and presenting strategic plans and annual budgets to the Board for discussion and decision.

The administrative governor redelegates to the chief operating officer (COO) responsibility for administrative oversight of the Board's operations and resources, and the COO redelegates to the chief financial officer (CFO) certain responsibilities and authorities. Specifically, the CFO has the responsibility and authority for

- formulating, approving, and implementing the Board's policies, operations, and resources related to financial management and control
- setting budget targets consistent with the strategic plan

³ 12 U.S.C § 244.

⁴ Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

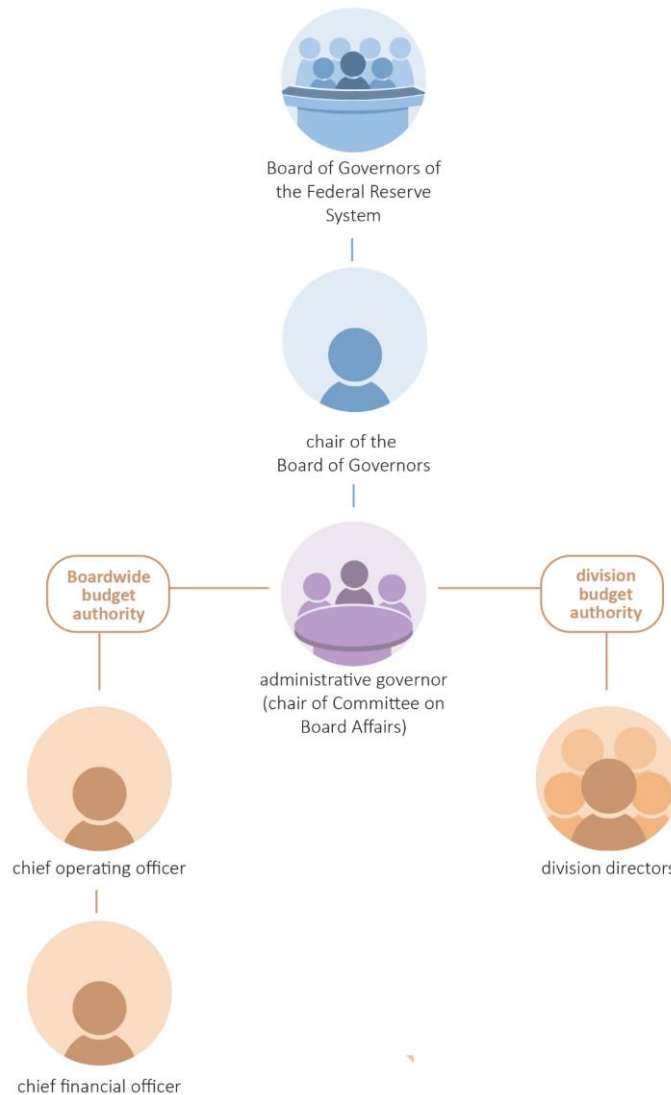
⁵ Board of Governors of the Federal Reserve System, *105th Annual Report*, 2018.

- chairing the Board’s annual budget and review process
- approving reallocations or overexpenditures of budgeted funds within the Board’s operating budget that do not exceed a certain dollar amount or percentage threshold
- approving reallocations of positions if the reallocation does not result in increases to the Board’s budget or total authorized position count

The administrative governor also delegates to the division directors the responsibility and authority to approve (1) certain reallocations of budgeted funds within their respective division budget and (2) reallocations of positions if the reallocation does not increase the division’s budget or total authorized positions.

Figure 1 illustrates the Board’s governance structure as it relates to the budget-related delegations of authority.

Figure 1. Board Governance Structure for the Budget Process



Source: OIG representation based on Board documents.

Roles and Responsibilities for Budgetary Activities

The Board generally develops its budget in a decentralized manner. The CFO, who is responsible for Boardwide financial management policies, is the director of the Division of Financial Management (DFM). Within DFM, the Financial Planning and Analysis section (FP&A) is responsible for managing budget development, analyzing and reporting on budget performance, and developing financial forecasts for the Board. Also within DFM, the Strategic Performance Office is responsible for efficiently and effectively measuring, monitoring, analyzing, and reporting on projects and performance related to the Board's strategic initiatives. FP&A partners with the Strategic Performance Office to report on the Board's strategic objectives.

Although DFM is responsible for managing budget development, analyzing and reporting on budget performance, and developing financial forecasts for the Board, each division develops and executes its own budget with DFM's support. FP&A works with budget contacts within each of the Board's divisions to formulate, execute, and monitor the Board's budget.⁶ Division budget contacts have a variety of backgrounds and experiences. Some division budget contacts are dedicated financial analysts whose primary responsibility is to manage the division's budget, while other division budget contacts are division administrators who fulfill their budget roles in addition to other administrative duties.

Given the Board's decentralized structure and the varying skill sets of budget contacts, DFM provides the divisions with tools and other support. FP&A provides the divisions with several informational documents on its internal budget website that address the key aspects of the Board's budget process, including general budgeting, forecasting, functional costing, and personnel cost budgeting. DFM also provides training on budget tools as well as ad hoc support to divisions throughout the process. DFM has noted that some divisions rely heavily on FP&A's assistance.

Key Aspects of the Board's Operating Budget

The following are key aspects of the Board's operating budget:

- **Strategic plan connection.** The Board's *105th Annual Report* states that the Board's budget is grounded in the principles established by the *Strategic Plan 2016–19* and provides funding to advance the strategic plan's goals, objectives, and initiatives. In addition to the strategic plan, each division develops a 2-year operating plan. The operating plan identifies the divisions' initiatives and projects and links them to a strategic objective and pillar in the Board's *Strategic Plan 2016–19*.
- **Growth targets.** The Board uses a target growth rate, endorsed by the CBA, to manage budget growth. The target growth rate is recommended by the COO and the CFO based on known and anticipated changes in the Board's ongoing operations, such as creating new positions and funding for the Board's compensation and benefit programs; strategic inputs, such as the Board's strategic plan and division operating plans; comparable organizations' targets; expense and position trends; and known cost drivers.
- **Forecasting.** The Board uses financial forecasting to help monitor its budget. Forecasting requires divisions to assess their business environments on a quarterly basis and update their division

⁶ The COO, the Division of Management, and DFM share division budget contacts.

assumptions and projections for a multiyear horizon within the forecasting system. The forecasts are intended to support the ongoing monitoring of the business environment, inform decisionmaking, and create a financial map that highlights divisions' current and long-term financial positions.

- **Personnel costs.** Because the Board's budget is primarily driven by personnel costs (personnel accounts for approximately 70 percent of the overall budget, with the remaining 30 percent goods and services), the Board incorporates in its budget an average-number-of-personnel measurement, which estimates the number of personnel required to support Board operations and helps the Board forecast the anticipated costs associated with employee benefits. Similarly, the Board incorporates a vacancy rate, which captures the percentage of authorized positions that are projected to be vacant and helps the Board estimate overall personnel costs.
- **Functional costing.** The Board uses a cost-accounting approach to formulate and execute its budget, which allows the Board's costs to be reported by account, division, and functional area. The Board groups the divisions into the following functional areas: Monetary Policy, Public Programs, Supervision and Regulation, Reserve Bank Oversight, and Support and Overhead. These five functional areas allow for an alternative view of Board operations based on why expenses are incurred.

The Board's budget process has two primary phases: formulation and execution. During the formulation process, divisions prepare and submit their individual budgets to FP&A. FP&A then compiles the division budgets to create the Boardwide budget. Throughout the course of the year, as the Board executes its budget, FP&A and the divisions monitor expenses, analyze variances, and report on budget performance to senior management. Certain monitoring activities, including forecasting, help inform the formulation of the following year's budget.

Efforts to Improve the Board's Operating Budget Process

The Board has historically faced challenges formulating and executing its annual operating budget. As such, since 2015 DFM has been implementing changes to improve key aspects of the budget process, including

- requiring the divisions to develop operating plans as a mechanism for connecting the budget to the Board's strategy
- establishing its functional accounting approach
- centralizing certain accounts
- implementing the use of forecasting
- implementing a new budgeting and forecasting system

In addition, since 2017, the Board has acknowledged that the budget was perennially underspent and that the number of vacancies was sufficient to accommodate future hiring needs. As such, the Board has focused on slowing growth and spending more consistently with budgeted amounts by

- limiting financial and position growth
- building the budget from forecasts instead of prior year budgets
- instructing divisions to align resources according to priorities and seek tradeoffs to reach both division targets and the collective functional area targets⁷

Management Actions Taken During This Evaluation

In 2019, the Board continued to implement changes to improve its budget process.

- The Board issued its *Strategic Plan 2020–23*, which is structured by budget functional area and aligns with the Board’s core mission. DFM also updated the division operating plan template to reflect the functional approach of the *Strategic Plan 2020–23* and include a focus on linking strategy and budget. The template contains the Board’s preliminary initiatives to support the goals and objectives, which divisions can support with their projects and initiatives.
- The Board delayed the 2020 budget process to ensure alignment between the Board’s *Strategic Plan 2020–23* and the 2020 budget. The delay will allow additional time to assess and incorporate certain strategic inputs. These strategic inputs include (1) the finalized *Strategic Plan 2020–23*, which will serve as a guiding principle for resource allocation and funding priorities; (2) division operating plans and budget estimates, which will incorporate division initiatives; and (3) updated data on personnel costs.
- FP&A began building a Functional Execution Team within its section that will support FP&A as it aims to centralize the Board’s six largest accounts, representing 90 percent of the budget. The team will use information obtained from the divisions to better understand division needs and translate that information into the forecasting model.
- The Board established a centralized pool of 14 unfunded positions; divisions can request positions to support their operations. To keep the pool filled, DFM is planning to recoup vacant positions (including funding for those positions) from divisions with a vacancy rate above the agency’s average vacancy rate. In 2019, the benchmark vacancy rate was 8 percent.

⁷ A *tradeoff* is the exchange of resources between or among business units that helps an organization achieve its enterprise-level priorities.



Finding 1: DFM Can Enhance the Design of Its Annual Operating Budget Process

Although DFM provides divisions with several informational documents and issues annual budget guidance, DFM has not documented and communicated the full budget process, including the connection between strategy and budget, in an overarching policy or other governing document. Internal control standards highlight the importance of establishing policies and procedures and communicating necessary information to personnel; leading practices suggest that organizations should align their budget and strategy. The Board’s budget process has been evolving since 2015, including strengthening the connection between budget and strategy. Nevertheless, DFM has not fully standardized its budget processes and documented and communicated those processes to all divisions. Documenting and communicating the budget process could help the Board improve transparency into key elements of the process, prioritize its funding, and monitor its progress against strategic goals.

DFM Can More Effectively Document and Communicate Its Budget Process

The Committee of Sponsoring Organizations of the Treadway Commission’s *Internal Control—Integrated Framework* and the U.S. Government Accountability Office’s *Standards for Internal Control in the Federal Government* highlight the importance of establishing policies and procedures, integrating them into the organization’s operations, and communicating necessary information to personnel.⁸ In accordance with the delegations of administrative authority, the CFO is responsible for the Board’s policies related to financial management.

Although DFM provides divisions with several informational documents and issues annual budget guidance, DFM has not documented the full budget process, with a description of the expected timing for budget activities, in a policy or other governing document. DFM developed its draft *From Strategy to Budget to Measurement*, which describes the overall process through which the Board strives to align strategy with budget and measure progress toward achieving its strategic goals. It also links to other relevant documents. However, this document is still in draft because the performance measurement component of the Board’s strategic planning process is not fully developed. As such, the document has not been widely distributed or posted to DFM’s internal budget website.

We note that DFM has been continually making changes to improve its budget process and has been issuing reference documents to describe new aspects of the process. In addition, DFM issues annual budget guidance and a budget calendar specific to that year. The annual budget guidance, the budget calendar, and other reference documents are posted to DFM’s internal budget website.

⁸ Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control—Integrated Framework*, May 2013; and U.S. Government Accountability Office, *Standards for Internal Control in the Federal Government*, GAO-14-704G, September 2014.

A lack of overarching guidance may create a lack of predictability or clarity in the process. Interviewees from two divisions noted that long-term planning is difficult given the uncertainty in the budget process. These interviewees also indicated that DFM does not set long-term expectations early in the process but rather requests information with short turnaround times. Multiple divisions indicated that FP&A provides a wide variety of information, but that the information can be cumbersome to navigate; divisions noted a desire for more summary-level information. Multiple divisions expressed interest in understanding certain elements of the process, such as the factors that are considered in the growth rate and the vacancy rate.

The Board's *Strategic Plan 2016–19* includes a strategic pillar for project development and resource allocation, and within that pillar is an initiative to develop and apply repeatable business processes across the organization, with supporting frameworks and models. Most of our benchmark organizations maintain a policy or other documents that facilitate a repeatable process, and the organizations supplement the overarching documents with annual guidance. One organization further supplements those with additional tools, such as budget submission templates, financial plans, staffing plans, and a checklist. Documenting and communicating the budget process in an overarching document can help the Board advance its strategic planning initiative and mature the budget process into a predictable, repeatable process. A more effectively documented budget process could also improve transparency into elements of the Board's budget, including both the growth and vacancy rate calculations.

DFM Can Strengthen the Connection Between Budget and Strategy

Connecting an organization's budget to its long-term strategy is a leading practice. In addition, GPRA, which the Board follows in spirit, requires federal agencies to publish a multiyear strategic plan and link their budget to the goals identified in the strategic plan. GPRA also requires agencies to link performance goals and outcomes to budgetary resources. The Board also notes the importance of connecting its budget to strategy: The Board's *105th Annual Report* states that the budget is grounded in the principles established by its strategic plan and provides funding to advance the plan's goals, objectives, and initiatives. In addition, the Board's internal *Budgeting 101* document states the budget should closely reflect the latest strategic plan to ensure that organizational resources are used to support the strategy.

In the spirit of GPRA, the Board publishes a strategic plan, an annual performance plan, and an annual performance report. In addition, DFM developed an operating plan template for divisions to use as a guide for establishing priorities, projects, and initiatives. All divisions developed these operating plans for 2019 budget formulation; however, the content of those operating plans varied across divisions. The divisions also provided us with varying descriptions of how they use their operating plans to develop their budget.

- Some divisions indicated that rather than leverage their operating plans to build their budget, they may base their budget on historical trends from prior years' budgets, adjusting for major changes or investments.
- Some divisions stated that their operating plan connects to their budget.
- DFM leadership and other divisions noted that in practice, the budget may be driving divisions' strategy rather than strategy driving budget.

The divisions may be inconsistently using operating plans because DFM does not have a policy describing the connection between strategic planning and budget. As noted previously, DFM has not developed an overarching budget policy, and divisions expressed interest in additional clarity into the overall process. Specifically, an interviewee expressed interest in more communication establishing the purpose and importance of division-level operating plans, as well as the plans' connection to the Board's overall strategic plan. They suggested sharing an example of a quality operating plan to aid divisions in their own operating plan development.

One Board division and our benchmark organizations identified other ways to strengthen the connection between budget and strategy. Interviewees from one Board division noted that the division created an internal tracking and reporting system to capture strategic initiatives in relation to the budget. One of our benchmark organizations established a cultural norm of strategy first, which originates at the top of the organization and is guided by an analysis of the potential for areas to shrink, remain stable, or grow. One organization links its budget to strategy by requiring divisions to identify the strategic goal and objective for every budget line item. This organization also annually publishes its budget, performance plan, and performance report in a single document. In this document, the organization reports on the resources allocated to each of its strategic priorities.

Establishing a stronger connection between budget and strategy may help the Board ensure that its organizational resources are used to support the strategy. Such a connection can also help the Board prioritize funding and monitor progress toward achieving its strategic goals. We note that the Board updated its strategic plan in 2019 to align with the agency's core mission. The Board also updated the operating plan template to include specific initiatives, performance measures, and performance targets that could support DFM in addressing this finding. However, because the strategic plan and operating plan template were issued outside the scope of our work, we did not have the opportunity to evaluate their effectiveness in strengthening the connection between budget and strategy.

Recommendation

We recommend that the CFO

1. Finalize and communicate the budget process, including the connection among strategy, budget, and performance, in an overarching document, and consider implementing additional methods or tools to reinforce DFM's expectations to the divisions.

Management Response

The Board concurs with our recommendation but believes that many of the fundamental budget aspects are already broadly documented and communicated. The Board states that DFM will create an overarching policy related to the Board's budget process. It also states that in 2020, DFM will hire consultants to focus on key areas, provide recommendations regarding more efficient and effective operations, and implement a comprehensive plan including execution strategies.

OIG Comment

The actions described by the Board appear to be responsive to our recommendation. We will follow up to ensure that the recommendation is fully addressed.



Finding 2: DFM Can Better Implement Its Annual Operating Budget Process

DFM can more effectively manage the execution of the approved budget Boardwide, in accordance with DFM's goal to promote sound financial decisionmaking by strengthening Boardwide financial management processes. Given the Board's decentralized structure, divisions manage their own financial and human capital resources, including updating their forecasts when actual results vary from budget estimates. Divisions generally underspend their budgets and maintain vacancies, but to varying degrees; some divisions have excess funds or positions, while others perform closer to their budget estimates. However, the CFO generally does not exercise the position's delegated authority to reallocate funds and positions among divisions because each division director also has the authority to manage their individual budget. In addition, divisions generally do not seek tradeoffs with other divisions, and DFM does not facilitate tradeoff discussions among divisions because it does not feel it has the authority to make prioritization decisions. Lastly, notification requirements may contribute to this underspending. Divisions appear to underspend their budgets, in part, because the CFO notification requirements apply only to exceeding budgets, not underspending. Implementing methods to execute the budget on an enterprise level can help ensure effective allocation of the Board's financial and human capital resources.

DFM Can More Effectively Manage Budget Execution Boardwide

In its *2019–20 Operating Plan*, DFM notes that it aims to promote sound financial and strategic decisionmaking in part by strengthening Boardwide financial management processes. In addition, a DFM official stated that it strives to manage the budget at a Boardwide level. To achieve these intentions, DFM should continue to strengthen budget execution Boardwide.

Given the Board's decentralized structure, each division manages its own financial and human capital resources with DFM's support. Divisions generally underspend their budgets, but to varying degrees. During 2017, divisions underspent their budgets by 0.7 percent to 8.0 percent; in 2018, divisions' spending ranged from 10.1 percent under budget to 0.5 percent above. Human capital resource allocation also differs by division. During 2017, division vacancy rates ranged from 0 percent to 13.4 percent; in 2018, division vacancy rates ranged from 1.9 percent to 12.9 percent. The divisions have the authority and responsibility to execute against their budgets and update their forecasts when actual results vary from budget estimates.

Recognizing the tendency of divisions to underspend their budgets, DFM has made efforts to strengthen Boardwide financial management processes with regard to budget formulation. Specifically, for the formulation of the 2019 budget, the CFO implemented budgetary strategies endorsed by the CBA to align budgeting with the divisions' historical spending trends. This effort included reducing certain centralized personnel and goods and services account budgets as well as normalizing division travel and training budgets. However, DFM can continue to strengthen financial management processes with regard to budget execution.

The delegations of administrative authority give the CFO the authority to manage the budget Boardwide, including the authority to approve certain reallocations of funds or positions among divisions. Even though some divisions have excess funds or positions at the end of the year while other divisions perform closer to their budgeted amounts, the CFO generally does not exercise the authority to reallocate funds or positions. To encourage collaboration among divisions, DFM created functional areas that overlap division lines and instructed the divisions to seek tradeoffs to reach both division targets and collective functional area targets. However, divisions indicated that they generally do not initiate or conduct tradeoffs with other divisions and that DFM does not facilitate tradeoff discussions. One division provided an example in which it needed additional funding for an initiative and DFM identified another division that potentially had excess funds. The two divisions had a conversation, but DFM did not facilitate that discussion, and a tradeoff did not occur.

In a 2017 report, we noted that the Board has a decentralized structure in which divisions can often operate independently to achieve their objectives.⁹ Board officials have noted that the decentralized structure has led to a consensus-driven culture, meaning that because the divisions often operate independently, the heads of the administrative functions find it challenging to implement initiatives when division directors are not in agreement. The Board's decentralized structure and its consensus-driven culture may affect DFM's ability to manage the budget Boardwide.

- Although the CFO has the authority to move funds and positions among divisions, division directors are delegated the authority to independently manage funds and positions within their budgets. The CFO highlighted challenges exercising the position's delegated authority because each division director also has the authority to manage their individual budget.
- DFM leadership and several division interviewees indicated that it is unclear who should make prioritization and tradeoff decisions. Specifically, even though DFM encourages collaboration within functional areas, those functional areas are not overseen by one individual authorized to make prioritization decisions. DFM also indicated that even if it participated in tradeoff conversations, it does not have the authority to make those tradeoff decisions.

Even though reallocations among divisions generally do not occur, DFM explained that it manages the budget holistically rather than by division. Therefore, because most divisions, and the Board as a whole, underspend, DFM notes that other divisions can exceed their individual budgets. Overspending is allowable up to a certain threshold; past that threshold, the division must notify and obtain approval from the CFO. Although divisions may overspend, in 2017 none of the 14 exceeded its budget. In 2018, DFM was the only division to exceed its budget (by \$0.1 million); the other divisions underspent their budgets by an aggregate \$27.8 million. Multiple divisions indicated that they are not inclined to exceed their budget because of the notification and approval requirements. One division noted that similar notification requirements do not apply to underspending. If divisions are not required to notify the CFO of underspending, through a memorandum or otherwise, they may continue to retain unused resources rather than making them available for allocation to other priorities.

Strengthening Boardwide budget execution may result in more effective allocation of financial and human capital resources. For example, although in 2017 and 2018 the Board underspent by \$36.7 million

⁹ Office of Inspector General, *The Board's Organizational Governance System Can Be Strengthened*, [OIG Report 2017-FMIC-B-020](#), December 11, 2017.

(4.9 percent) and \$27.7 million (3.6 percent), respectively, one division noted an instance in which an initiative went unfunded because the division did not have sufficient funds. With respect to human capital resources, although at year-end in 2017 and 2018 the Board held 241 (8.5 percent) and 207 (7.3 percent) vacancies, respectively, one division noted challenges in obtaining necessary human capital resources. The lack of (1) tradeoff conversations between divisions, (2) one individual authorized to make prioritization decisions, and (3) requirements for divisions to notify the CFO of expected underspending may result in a misalignment of resources and may hamper divisions' ability to implement initiatives or priorities.

DFM Should Consider Other Approaches That May Promote a More Effective Execution of the Board's Budget

Our benchmark organizations manage budget execution at the enterprise level and note the importance of centralized budget processes to the effective execution of the organization's budget. One organization holds midyear budget reviews to identify potential unfunded needs and surpluses and to facilitate budget adjustments. That organization's CFO noted that if a division is not expected to use its funds as intended and cannot justify using those funds for another initiative, the CFO collects the funds. Those funds are then available to be allocated to another division. With regard to positions, one organization's CFO moves vacancies into a central reserve of positions, while another organization has senior officials conduct tradeoffs across the divisions to optimize human resource allocation based on organizational strategy.

DFM has begun implementing changes to help improve its budget execution processes. As it continues to make changes, DFM should determine the most effective way to do so considering the Board's decentralized structure and its culture. One organization that centralized most of its budget functions emphasized the importance of socializing those changes with senior leadership across the organization to obtain buy-in and build support. In addition, many Board divisions expressed the importance of having someone who understands their business needs and acts as a division advocate. Multiple Board divisions indicated a desire to have a centralized group to generate useful tools or reports tailored to the divisions' needs and to inform decisionmaking within the divisions.

Given the Board's decentralized structure, committees may help to facilitate prioritization discussions or set Boardwide priorities. Two benchmark organizations use committees to oversee budget functions and inform prioritization decisions. According to its charter, the CBA is responsible for overseeing the Board's planning and budget process, coordinating the work of oversight committees as they plan to budget for their particular areas, and supporting the COO in allocating resources among competing priorities to achieve the Board's objectives. Thus, the CBA could serve as a good forum to set Boardwide priorities. Some division directors have also noted that the Executive Committee, a committee chaired by the COO and comprising the other division directors, may be a good forum in which to facilitate prioritization discussions. According to its charter, the Executive Committee creates an environment that encourages divisions to work together toward a unified perspective that aligns the resources and objectives of divisions and offices with the broader objectives of the Board.

The Board can more effectively allocate resources to achieve organizational priorities and execute its budget on an enterprise level. This enhancement can be achieved through a strong tone at the top in

making enterprisewide prioritization decisions and determining the most effective way to centralize certain aspects of the budget process. We note that, in 2019, the Board began centralizing areas of the budget process, including building a centralized functional execution team, centralizing certain accounts, and centralizing a pool of positions that could support DFM in addressing this finding. Because these changes were implemented outside the scope of our evaluation, we did not have the opportunity to evaluate their effectiveness in managing the budget Boardwide.¹⁰

Recommendation

We recommend that the CFO and the COO, in coordination with the administrative governor,

2. Identify, develop, and implement methods to more effectively execute the Board's budget on the enterprise level. In doing so, the CFO and the COO should consider the delegated authorities, organizational structures, and policies available to make prioritization decisions. The CFO and the COO should also consider other techniques to transition toward an enterprise view of the budget, including accountability measures for division resource management.

Management Response

The Board concurs with our recommendation but believes that the current organizational structure limits the ability to develop additional techniques to manage budget execution. The Board notes that the CFO and COO will meet with division directors individually when budgetary issues arise within their division and that the CFO will provide regular budget updates at Executive Committee meetings. The Board further notes that the administrative governor and the COO are developing a division director scorecard that will incorporate resource management to be used in annual performance assessments between division directors and oversight governors. Lastly, the Board describes actions it has taken to transition to a more enterprisewide view of the budget: (1) creating a centralized position pool starting with the 2019 budget, (2) building a functional execution team providing centralized financial planning services by functional area, (3) constituting a Technology Investment Committee to help ensure senior leadership reviews and prioritizes technology projects funded within the budget, and (4) seeking to partner with divisions to create and report on metrics and measures for initiatives aligned with the Board's *Strategic Plan 2020–23*.

OIG Comment

The actions described by the Board appear to be responsive to our recommendation. We will follow up to ensure that the recommendation is fully addressed.

¹⁰ Our 2017 governance report has two open recommendations that could further support the Board in addressing the recommendations in this report. We recommended that the governors communicate and reinforce their expectations of the heads of enterprisewide administrative functions and consider mechanisms to hold division directors accountable for their role in those administrative functions. We also recommended the implementation of processes to report on enterprisewide actions to ensure compliance with policies created by the heads of the administrative functions.



Appendix A: Scope and Methodology

Our objective was to assess the design and implementation of the Board’s processes for formulating and executing its annual operating budget. We focused on governance over the budget process, including budget policies, procedures, or guidance; delegations of authority; organizational structures; and communication. We also focused on the strategic plan connection, division’s budget contact preparedness and training, and position management. Our scope for this evaluation was 2018 budget activities, including execution of the Board’s 2018 operating budget (January 2018–December 2018) and formulation of the 2019 operating budget (May 2018–December 2018). To achieve our objective, we

- reviewed applicable federal laws, regulations, and Board documents, including
 - section 10 of the Federal Reserve Act
 - Government Performance and Results Act of 1993 and the GPRA Modernization Act of 2010
 - the Board’s delegations of administrative authority documents—specifically, *Delegations from the Board to the Chair and the Inspector General*, *Chairman’s Delegations of Administrative Authority*, *Administrative Governor’s Delegations of Administrative Authority*, and the *Chief Operating Officer’s Delegations of Administrative Authority*
 - the Board’s strategic planning documents, including *Strategic Plan 2016–19*, *Annual Performance Report 2018*, and 2018 division operating plans
 - the Board’s *104th Annual Report* and *105th Annual Report*
 - the Board’s *2018 Budget Guidance*, *2019 Budget Guidance*, and the *2019 Board Budget and Planning Calendar*
 - the Board’s *2018 and 2019 Budget as Approved by the Board of Governors*
 - other internal Board documents
- interviewed representatives from DFM, specifically in FP&A and the Strategic Performance Office
- interviewed division representatives from all 14 divisions, including budget contacts from all 14 divisions and 11 division directors¹¹
- analyzed budget data for 2017 and 2018 to identify trends in financial and human capital resources and to assess budget contact qualifications against division budget performance
- benchmarked with four organizations (three other nonappropriated agencies and one financial institution)
- reviewed relevant OIG reports and reports from other federal agencies
- reviewed literature and other public information regarding leading budget practices

¹¹ Although 11 division directors were interviewed, all 14 were invited to participate. In addition, to maintain our independence, we excluded the OIG from this evaluation.

We conducted our fieldwork from February 2019 to October 2019. We performed our evaluation in accordance with the *Quality Standards for Inspection and Evaluation*, issued in January 2012 by the Council of the Inspectors General on Integrity and Efficiency.

Appendix B: Management Response



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

DIVISION OF
FINANCIAL MANAGEMENT

March 10, 2020

Cynthia Gray
Senior OIG Manager
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Cynthia

Thank you for the opportunity to comment on the draft report, *The Board Can Further Enhance the Design and Implementation of its Operating Budget Process*. We appreciate the Office of Inspector General's (OIG) effort in developing this report and the recommendations for strengthening the Board's budgetary process and improving the linkage between the Board's budget and strategy.

There were two findings noted in the report with recommendations listed under each finding. We agree with the recommendations offered in the report and provide our response for each recommendation to the OIG.

We value your objective, independent viewpoints and appreciate the professionalism demonstrated by all OIG personnel throughout this audit. We look forward to working with your office in the future.

Regards,

A handwritten signature in black ink that reads "Ricardo Aguilera".

Ricardo Aguilera
Director and CFO, Division of Financial Management
Federal Reserve Board

cc: Pat McClanahan, Chief Operating Officer

www.federalreserve.gov

Response to Recommendations Presented in the Draft IG Report, “The Board Can Further Enhance the Design and Implementation of its Operating Budget Process”

Recommendation 1: Finalize and communicate the budget process, including the connection among strategy, budget, and performance, in an overarching document, and consider implementing additional methods or tools to reinforce DFM’s expectations to the divisions.

Management Response: DFM agrees with this recommendation. Specifically, DFM will create an overarching policy related to the Board’s budget process. However, we believe most of the fundamental building blocks of the policy, process, methods, and expectations are already broadly documented and communicated to the Committee on Board Affairs and Board divisions. In 2020, DFM will hire consultants to focus on key areas, provide recommendations regarding more efficient and effective operations, and implement a comprehensive plan including execution strategies.

Recommendation 2: Identify, develop, and implement methods to more effectively execute the Board’s budget on the enterprise level. In doing so, the CFO and COO should consider the delegated authorities, organizational structures, and policies available to make prioritization decisions. The CFO and COO should also consider other techniques to transition toward an enterprise view of the budget, including accountability measures for division resource management.

Management Response: DFM agrees with this recommendation but believes the current organizational structure limits additional techniques to manage budget execution.

- The Board has historically under-executed its operating budget by a significant amount, averaging 2.5% from 2014 through 2018. Budget underruns have been primarily driven by over-optimistic budgeting across the organization. For example, budget under-execution was \$36.8 million in 2017 and \$28.5 million in 2018, excluding the Survey of Consumer Finances. Recent efforts by DFM’s centralized budget function have successfully reduced budget under-execution, taken reasonable execution risk, and produced forecasts that are more reliable. For 2019, budget under-execution was \$5.2 million, or 0.7%, which was the lowest in ten years.
- DFM will build on this success in 2020. However, budget execution does not solely reside within DFM’s centralized budget function. Divisions have the authority and responsibility to effectively execute against their budgets, and inform DFM through the forecasting process when actual results may vary from plan so that under-execution can be reprioritized or over-execution can be properly managed.

- The COO and CFO will meet with division directors on an individual basis when budgetary issues arise within their division. The CFO will also provide regular budget updates at Executive Committee meetings.
- The Administrative Governor and COO are developing a Division Director scorecard to be used in annual performance assessments between Division Directors and Oversight Governors that will incorporate resource management as one of the measured performance areas.

In addition, DFM has taken steps to transition toward a more enterprise view of the budget.

- DFM set up a centralized position pool starting with the 2019 budget. We will use the pool positions for strategic areas of growth. The CFO, CHCO, COO, and Administrative Governor approve position requests from divisions to the pool.
- For 2020, DFM set up a functional execution team, which provides centralized financial planning services by functional area. The team will help divisions implement budget execution, monitoring, and reporting responsibilities and centralize the use of the Board's budget and forecasting system, focusing on the accounts that drive financial performance of the functional area. The functional execution team will augment the work already performed within DFM to improve the Board's budget process through the use of centralized budgeting and analysis of the largest accounts that drive financial performance. Currently, division inputs into the quarterly forecasting process are too optimistic and understate underruns that lead to unnecessary tradeoffs. The functional execution team will help improve forecasting accuracy and capabilities and provide more timely, accurate, and relevant financial insights and recommendations to senior leaders and governance groups.
- The CFO and CIO are constituting a Technology Investment Committee (TIC) comprised of senior leaders from across the Board. The TIC will review all new technology projects for redundancy, prioritize technology requests, and recommend approval and funding for prioritized requests. The TIC will help make tradeoffs and ensure senior leadership reviews and prioritizes technology projects funded within the budget and ensures they align the Board's strategic plan and division operating plans. Existing governance groups, including the Investment Review Board, will continue to operate in 2020.
- Along with the consulting aspects mentioned in Recommendation 1, DFM seeks to partner with divisions to create and report progress on metrics and measures for initiatives aligned with the Board's 2020-23 Strategic Plan as part of the quarterly strategic reporting process.



Abbreviations

CBA	Committee on Board Affairs
CFO	chief financial officer
COO	chief operating officer
DFM	Division of Financial Management
FP&A	Financial Planning and Analysis
GPRA	Government Performance and Results Act of 1993, as amended by the GPRA Modernization Act of 2010

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