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Auditor Independence and the Federal Reserve

The release of rigorous new auditor independence standards last week by the U.S. General Accounting Office raises several questions about the Federal Reserve's engagement of a Big Five accounting firm to simultaneously conduct audits of the twelve regional Federal Reserve Banks and provide management consulting services. The GAO unveiled the new government guideline amid widespread concern over accounting industry practices in the wake of Enron's recent collapse.

In 2000, the Fed paid PriceWaterhouseCoopers LLP (PwC) \$1.4 million to audit the individual and combined financial statements of the Reserve Banks and an additional \$200,000 to audit the Fed's pension and thrift savings plans. At the same time, the central bank contracted with PwC to provide consulting services for a major revamping of the Fed's check-processing capacities. PwC is still under contract to audit the Reserve Banks 2001 financial statements and furnish the consulting services through 2003.

The Fed's dual relationship with PwC was first reported in a special section on Federal Reserve annual reporting practices in the [June-July 2001 edition](#) of the Financial Markets Center newsletter *FOMC Alert*.

That report was based on disclosures contained in the Federal Reserve Bank (FRB) of Cleveland's 2000 annual report (AR). In its AR, the Cleveland Fed noted that it had entered into "a systemwide contract" with PwC for consulting services on the central bank's Check Modernization Project. According to FRB Cleveland, PwC received \$800,000 for consulting work on the project in 2000 and will collect an additional \$2.5 million through 2003.

Later, the Board of Governors separately disclosed in its 2000 annual report that PwC had received a total of \$1.5 million for management consulting work (including the services disclosed in the FRB Cleveland report) with the Board and the Reserve Banks in 2000. Both the Board of Governors annual report and its counterpart from the Cleveland Fed asserted that the consulting contract was "not incompatible" with PwC's audit responsibilities. But neither AR explained how the Board of Governors or the FRB Cleveland board of directors arrived at this determination.

The fact of a dual audit-consulting relationship does not necessarily mean the central bank or PwC has done anything improper. Still, PwC's ongoing contract for non-audit services poses three timely questions: Does the consulting work performed by PwC fall within the permissible activities described in GAO's new auditor independence standard? Will the central bank adopt that new standard at both the Board of Governors and the Reserve Bank level? And, if so, will it apply the standard in awarding its next contract for external audits of financial statements in 2002 and future years?

Background: Audits of Federal Reserve Financial Statements

Under the Inspector General Act, the Office of Inspector General at the Board of Governors¹ contracts with an external accounting firm to annually audit the Board's financial statements using

¹ Unlike inspectors general at most major federal agencies, who are appointed by the president subject to Senate confirmation, the central bank's IG serves at the pleasure of the Fed's chairman. The Fed's IG does not have authority over the regional Reserve Banks.

generally accepted Government Auditing Standards (GAGAS) issued by the General Accounting Office. GAGAS – widely known as the Yellow Book – now includes the revised auditor independence standard released by GAO on January 25, 2002 (see below).

Beginning in 1994, the Board of Governors began commissioning routine outside audits of the Reserve Banks’ combined and individual financial statements too – largely in response to pressure from key members of Congress and the GAO. In consultation with Reserve Bank officers and directors, the Board’s Reserve Bank Operations and Payment Systems (RBOPS) Division awards contracts for these audits through a competitive bidding process similar to but separate from the inspector general’s selection of the Board’s external financial auditor.

Unlike its Board counterpart, however, the Reserve Banks’ outside auditor employs nongovernmental generally accepted auditing standards rather than GAGAS. Even though [GAO urged the Fed to use GAGAS for the Reserve Banks’ external audits](#), even though GAGAS are used in audits of many nongovernmental entities (including recipients of federal grants and contracts), and even though the Reserve Banks have many public-sector features,² the Board has instructed the Banks’ outside auditors to use private-sector standards on the premise that the Banks function more like businesses than federal entities.³

Over the years, the central bank has maintained a steady contractual relationship with PwC and its predecessors Coopers & Lybrand and Price Waterhouse. In 1994, the Board hired Coopers & Lybrand to conduct the first five years of annual Reserve Bank financial audits and PwC remains under contract to audit the Reserve Banks’ 2001 financial statements. (Audit reports on the Reserve Banks’ combined financial statements first became widely available to the public when the Board incorporated the document in its 1998 annual report.) In addition, Price Waterhouse and Coopers & Lybrand performed the annual audit of the Board of Governors’ financial statement for 15 consecutive years from 1983 to 1997.⁴

Publicly Released Audits of Financial Statements for:		
Year	Board of Governors	Federal Reserve Banks
1978-1982	Arthur Andersen	N/A
1983-1988	Price Waterhouse	N/A
1989-1992	Coopers & Lybrand	N/A
1993-1997	Price Waterhouse	N/A
1998-2000	Deloitte & Touche	PriceWaterhouseCoopers

SOURCE: *Annual Reports*, Board of Governors of the Federal Reserve System

² The Banks are congressionally chartered public-purpose corporations supervised by their own boards of directors and the Fed’s Board of Governors. In the course of litigation, various courts and some of the Reserve Banks themselves have asserted that the Banks are government entities.

³ The Federal Accounting Standards Advisory Board specifically exempts the Federal Reserve System from the “government-wide reporting entity” using federal financial accounting standards. The Board of Governors employs generally accepted accounting principles (GAAP) while the Reserve Banks keep their books using non-GAAP standards laid out in the *Financial Accounting Manual for Federal Reserve Banks*. Developed by the Board of Governors to reflect “the significantly different nature and function of a central bank as compared to the private sector,” the in-house standards differ from GAAP primarily in two respects. Reserve Banks report their security holdings on an amortized-cost rather than fair-value basis and account for matched sale-purchase transactions as separate sales and purchases rather than secured borrowings. And unlike users of GAAP, the Reserve Banks do not report statements of cash flows.

⁴ PwC alumni also populate the Fed’s internal audit operations. For example, David Sheehe, general auditor of the Federal Reserve Bank of New York – the Bank most critical to overall monetary policy and supervisory operations – is a 32-year veteran of Coopers & Lybrand and Price Waterhouse.

In response to a July 2001 query from the Financial Markets Center, the Board stated that it “considers potential conflict-of-interest issues prior to contract award for audit services and ensures that the Board and Banks make appropriate disclosures in the annual reports regarding any *material* non-audit services performed by the audit firm [emphasis added].” The Board also noted that “the 2000 annual reports are the first in which the Federal Reserve has disclosed formally this information, which is intended to be comparable with SEC-mandated disclosures in corporate proxy statements.”

The New Government Auditor Independence Standard

The auditor independence standard issued by GAO on January 25 establishes a set of rules based upon two “overarching principles:” auditors should not perform management functions or make management decisions; and auditors should not audit their own work or provide non-audit services that “are significant/material to the subject matter of the audit.”

In adopting these rules, the GAO established a notably tougher standard than comparable private-sector measures set forth in the American Institute of Certified Public Accountants’ (AICPA) Code of Professional Conduct. Though the standard developed against a backdrop of growing concerns over so-called “scope of service” issues in the corporate economy,⁵ the GAO initially swung into action because of longstanding disputes between the accounting industry and government auditors over the breadth, clarity and applicability of independence rules rather than worries about federal agencies purchasing consulting services from their external auditors.⁶

During the three years that GAO mulled revisions to its auditor independence standard, public comments on draft documents gradually focused the agency’s attention on scope-of-service concerns. GAO was also strongly influenced to move in this direction by its [Advisory Council on Government Auditing Standards](#) – a blue-ribbon group that includes Federal Reserve Inspector General Barry Snyder and PwC executive Jacquelyn Williams-Bridgers, a former State Department Inspector General.

When GAO released an exposure draft of its scope-of-service rules in May 2001, [AICPA protested bitterly](#), complaining that the GAO standard was overly complex and restrictive – and that “the profession, not the government, should promulgate independence standards for auditors.” Despite AICPA’s objections, the standard released last week left the exposure draft largely intact and established tight restrictions on GAGAS auditors providing bookkeeping, appraisal, actuarial and other services to audit clients.

The Fed and PwC

Given the central bank’s disclosures to date, it is not immediately obvious whether PwC’s Check Modernization Project consulting work will significantly or materially affect the Reserve Banks’ financial statements and the Fed’s pension fund system. However, it is obvious that the Fed expects Check Modernization to have a substantial impact on its future operations.

While serving as regulator of the nation’s payment system the Fed also reaps substantial income from check processing and other priced services. In 2000, these services generated \$882 million of revenue for the Reserve Banks.

⁵ According to the SEC, one quarter of all publicly traded companies contracted for non-audit services from their auditors by 1999. Between 1993 and 1999, the accounting industry’s consulting revenues grew nearly three times faster than audit revenues on an average annualized basis. Non-audit services now account for half of total revenue at Big Five accounting firms.

⁶ A preliminary views document, issued by GAO in April 2000, focused on organizational independence issues for auditors. A GAO official involved in developing the new auditor independence standard says the practice of federal entities purchasing non-audit services from their auditors “probably doesn’t happen a tremendous amount.”

Though this amount represents only three percent of total Reserve Bank income – interest on the Banks’ vast holdings of Treasury and agency securities accounts for almost all the remaining 97 percent – priced services remain by far the largest single category of employment at the Reserve Banks, providing more than twice as many jobs as the Banks’ supervision and regulation divisions and six times as many positions as monetary and economic policy activities. (Overall, the Reserve Banks and their branches account for more than nine out of ten jobs in the Federal Reserve System.)

In the two decades since passage of the Monetary Control Act, however, payment-service operations at the Reserve Banks have encountered increasing private sector competition. The Check Modernization Project represents the Fed’s most concerted attempt yet to respond to that competition and speed the standardization of payment innovations.

The Board of Governors calls the five-year Project “one of the most significant operational efforts the Federal Reserve Banks have ever undertaken” and says “it will directly affect about 5,500 Federal Reserve employees” by streamlining the processing of 17 billion checks the Fed handles annually. Under the aegis of Check Modernization, the Fed will replace a hodge-podge of software applications in use at each Reserve Bank with common software, establish a national check-image archive and institute Web-based check services, all of which is intended to satisfy industry demands for uniform services as commercial banks consolidate across state lines.

According to inspector general reports and Board budget documents, the central bank plans to spend approximately \$270 million – \$106 million in 2002 alone – for hardware, software, personnel and other costs involved in the undertaking.⁷ As it rationalizes priced-services operations and centralizes key processing functions at various Reserve Banks, the Project almost certainly will have material impacts on the volume of Reserve Bank income and expenses and the way those items are booked on Reserve Bank financial statements.

Only more complete disclosure by the Fed, however, can satisfactorily address the question of whether PwC’s consulting services should be considered “material” with respect to GAO’s new auditor independence standard. The central bank could provide that disclosure in the form of additional public information on PwC’s Check Modernization contract and an analysis of its materiality as defined by the GAGAS rules.

GAO’s new standard also constitutes an implicit challenge to the central bank to model best audit practices in the future, even if it means adding another chapter to the long-running public-or-private debates surrounding the Reserve Banks. Conceivably, the Fed could meet this challenge either by selectively adopting the GAO independence standard to govern all central bank dealings with external audit firms or by making a wholesale shift from AICPA to GAGAS rules for Reserve Bank audits.

At present, the Board is in the middle of reviewing bids for the next batch of Reserve Bank external audits. Thus, in addition to choosing the auditor-independence standard that will guide its actions over the long haul, the central bank must also decide where it stands in the short term.

Historical Background on Audits of the Federal Reserve

The current system of external audits at the Federal Reserve grew out of a contentious history involving numerous congressional attempts to subject the secretive central bank to the same kind of General Accounting Office oversight applied to other federal entities. When these efforts reached a crescendo in the 1970s, the central bank organized a range of political interests to

⁷ Despite the magnitude of its investment, the Fed has run into some snags. According to recently released budget documents, consulting fees for Check Modernization apparently constituted the single largest portion of \$9.5 million in total Reserve Bank cost overruns during 2001. And software vendor delays pushed back the planned start-up of a check imaging archive at FRB Cleveland for nearly a year.

insist that GAO audits would undermine the conduct of monetary policy and compromise the confidentiality of both bank examinations and international monetary relations.⁸

Eventually, the 1978 Federal Banking Agency Audit Act granted GAO the authority to review most central bank operations unrelated to monetary policy. For the next decade, the issue of external audits at the Fed remained relatively dormant until former House Banking Committee Chairman Henry B. Gonzalez launched a series of inquiries into central bank practices. Even though Gonzalez' efforts helped convince the Fed to voluntarily commission outside audits, congressional calls for statutory reform persisted throughout the 1990s.

In 1999, Senator Harry Reid (D-NV) inserted an amendment in the Gramm-Leach-Bliley (GLB) Act imposing fairly stringent independent audit requirements on the Fed. Like most of its proposed forbears, Reid's measure exempted the central bank's monetary policy operations from outside audits. However, it called for the central bank to obtain independent audits of both its priced services operations and consolidated systemwide activities. And it required the Reserve Banks to employ GAAP accounting (though not Government Auditing Standards).

Predictably, the Fed objected to Senator Reid's amendment and convinced Congress to replace it with a bare-bones provision that essentially formalized the central bank's existing practice. As a result, the GLB Act signed by President Clinton requires only that the Board of Governors "order" an annual independent audit of financial statements filed by each Reserve Bank as well as the Board itself – with no definition of the term "independent" and none of the additional auditing authority sought by Senator Reid. Since Reid has also been a persistent critic of the central bank's dual regulator-competitor role in the payment system, it seems unlikely that he expected the Fed's independent auditor would also turn out to be its main consultant in a landmark effort to preserve and expand market share in the priced-services arena.

The Fed, Enron and Auditor Independence Concerns

Growing public interest in auditor independence issues stems largely from the recent failure of Enron Corporation and the role that Enron's auditor may have played in that debacle. Like most major institutions of government, the Federal Reserve figures in some facets of the Enron saga.

At the (apparently) small-scale-curiosity end of the spectrum, former Enron CEO Jeffrey Skilling served in 2001 as chairman pro tem of the Houston branch of the Federal Reserve Bank of Dallas. And Chairman Alan Greenspan, the most recent recipient of the Enron Prize for Distinguished Public Service from Rice University's Baker Institute for Public Policy, fielded a warning phone call from Enron head Kenneth Lay in late October (the Fed has not described the substance of the call but says Greenspan declined to take action in response to it).

Much more importantly, the central bank played a key role in fashioning the deregulated landscape in which Enron's opaque financial activities flourished and eventually brought the company and its outside auditor to grief. Under Greenspan's leadership, the Fed (along with most other regulatory agencies) enthusiastically endorsed the Commodity Futures Modernization Act of 2000, which exempted Enron's derivatives activities from public-sector oversight.

The Fed also played a central role in shaping the Gramm-Leach-Bliley Act,⁹ which enabled J.P. Morgan Chase and Citigroup to simultaneously become lenders and investment bankers to Enron

⁸ The Arthur Burns Papers at the Gerald R. Ford Presidential Library contain a number of documents chronicling the Fed's efforts to rebuff GAO audits during Burns' tenure as chairman. The campaign included an extensive mobilization of private-sector groups that caused Comptroller General Elmer Staats to complain, "unlike the Federal Reserve Board, I did not go out and try to organize a lobby." According to political scientist Kevin Corder, who has examined Burns' Papers, the Fed fashioned much of its audit-avoidance strategy by playing Congress and the White House – each of which was seeking greater Fed accountability through different mechanisms – off against each other. "The play between these competing forces has given us a very useful maneuvering flexibility that has assisted us in the accomplishment of our legislative ends," noted a Board memo written in 1977.

while reportedly holding equity stakes in the company. (Many analysts have commented on GLB's removal of barriers between commercial and investment banking in relation to Enron but few have focused on the potentially far greater relevance of [GLB's merchant banking provisions](#) weakening the traditional wall between banking and commerce.) Though GLB granted the Fed expansive umbrella supervision powers, [it did nothing to extend regulatory oversight to the panoply of unsupervised financial players and transactions epitomized by Enron](#) and its high-flying activities.

On the narrower matter of auditor independence standards, the Fed has kept itself mostly at the margins of public policy debate. In a September 2000 SEC hearing, however, [former Governor Laurence Meyer supported an SEC proposal to clamp down on the outsourcing of internal audits](#) – one of nine services a subsequent SEC rule sought to prevent accounting firms from providing to their audit clients. “High-quality accounting standards potentially can be nullified by a *perception* that auditors lack independence and objectivity in their enforcement role,” Meyer presciently observed. “Significant erosion of the public’s confidence regarding auditor independence could have severe consequences for investors, creditors and those seeking capital.”

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⁹ In his comprehensive history *The House of Morgan*, Ron Chernow famously and accurately labeled former J.P. Morgan director Alan Greenspan “the tutelary spirit behind Glass-Steagall repeal.”