

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MEMO

OFFICE OF INSPECTOR GENERAL

DATE: December 14, 2005
To: Board of Governors
FROM: Barry R. Snyder 
SUBJECT: 2006-07 Proposed Budget for the Office of Inspector General

ACTION REQUESTED

Approval of the 2006-07 Budget for the Office of Inspector General as itemized below:

1. An operating budget of \$10,237,480. This figure represents an increase of \$1,704,275 for the biennium or about 9.5 percent annually. The budget provides for thirty-six positions.
2. A capital budget of \$6,800; a 52.8 percent decrease over the previous budget.

DISCUSSION

The Office of Inspector General's budget will allow us to continue our legislated mandate of conducting audits, investigations, and other reviews to help improve the economy, efficiency, and effectiveness of Board programs and operations and to help prevent and detect fraud, waste, and mismanagement. As discussed in the attached, this budget represents an increased level of effort, largely driven by legislative requirements; goals and objectives that the Board has outlined in its strategic and biennial performance plans; and ongoing investments to attract and retain our human capital. Our operating budget includes an increase of 9.1 percent for personnel services that primarily reflects additional salary expenses for five positions: two audit staff to provide more complete, risk-focused coverage of the FISMA inventory; two audit staff to perform SOX-related work; and one administrative staff to provide clerical, office automation, and administrative back-up support. To the extent possible, the OIG has attempted to self-fund these positions by using salary lapse; allowing zero growth in travel expenses, supplies, and miscellaneous expenses; and decreasing operating funds in software, furniture and equipment, books and subscriptions, depreciation, and the IRM user charge. The contractual professional services and tuition categories are the only goods and services accounts that will increase over the two-year budget period primarily for SOX-related and financial statement work, resulting in a net increase in goods and services of about 253,000, or 12.8 percent annually. Our capital budget totals \$6,800, a decrease of \$23,700, or -52.8 percent annually.

Our budget was prepared in a manner that is administratively consistent with the preparation of the Board's operating budget, but is submitted separately to reflect the independence of the office.

**Inspector General's Analysis of the Budget Request
91011 Program Direction**

| Account Classification | 2004-2005 Base | 2006-2007 Request | Difference | Average Annual % Chg. |
|--------------------------------------|--------------------|----------------------|--------------------|-----------------------------|
| Salaries | \$6,505,269 | \$7,805,875 | \$1,300,606 | 9.5 |
| Retirement/Thrift Plans | 703,308 | 813,484 | 110,176 | 7.6 |
| Insurance | 394,938 | 435,084 | 40,146 | 5.0 |
| Subtotal Personnel Services | \$7,603,515 | \$9,054,443 | \$1,450,928 | 9.1 |
| Travel | 202,000 | 202,000 | 0 | 0.0 |
| Stationery & Supplies | 8,500 | 8,500 | 0 | 0.0 |
| Software | 65,550 | 50,200 | (15,350) | -12.5 |
| Furniture & Equipment | 190,000 | 180,000 | (10,000) | -2.7 |
| Rentals | | 15,680 | 15,680 | 0.0 |
| Books & Subscriptions | 1,500 | 600 | (900) | -36.8 |
| Contractual/Professional | 240,500 | 475,000 | 234,500 | 40.5 |
| Tuition/Registration/Members | 147,400 | 191,500 | 44,100 | 14.0 |
| All Other | 6,600 | 6,600 | 0 | 0.0 |
| Depreciation | 28,628 | 14,489 | (14,139) | -28.9 |
| IT User Change | 39,012 | 38,468 | (544) | -0.7 |
| Subtotal Goods & Services | \$ 929,690 | \$1,183,037 | \$253,347 | 12.8 |
| Operating Funds | \$8,533,205 | \$10,237,480 | \$1,704,275 | 9.5 |
| Capital | \$30,500 | \$6,800 | (\$23,700) | (52.8) |

Inspector General's Summary and Highlights

During the upcoming planning period, the Office of Inspector General (OIG) will continue to carry out its overall legislated mission to conduct and supervise independent and objective audits, investigations, and other reviews to help improve the economy, efficiency, and effectiveness of Board programs and operations and help to prevent and detect fraud, waste, and mismanagement. We expect, however, that the scope and breadth of our work will continue to grow over the biennium as we address new or expanding Board initiatives and key legislative mandates. Our work continues to be designed around our performance indicators to identify quantifiable savings or budget reallocations, operational efficiencies, improved program performance, enhanced compliance with applicable laws and regulations, effective fraud prevention and detection, and improved internal controls.

The OIG developed a new strategic plan in November 2004 that outlines our long-range direction through 2008 and delineates how we plan to carry out our duties and responsibilities. Our strategic goals are to

- provide timely and high-quality services that foster the Board's mission, goals, and values, and comply with applicable standards;
- enhance coordination, communication, and information sharing with the Congress, IG community, and others; and
- enhance the efficiency and effectiveness of our internal operations.

Our last four semiannual reports (covering the period of October 1, 2003, through September 30, 2005) summarize our more recent products and accomplishments. During this past two-year budget period, the OIG completed twenty-three audits, reviews, and other assessments; conducted a number of follow-up reviews to evaluate action taken on earlier recommendations; and performed numerous legislative and regulatory reviews. Specifically, highlights of our work include conducting annual and related reviews of the Board's information security program pursuant to FISMA; conducting reviews of failed financial institutions that the Board supervises and regulates; and evaluating emergency preparedness and security enhancements the Board has made post 9/11/01. We also contract for, and oversee the work of, an independent public accounting firm to fulfill the Board's statutory requirement for annual, audited financial statements. In addition, the OIG closed nineteen investigations; most recently, our investigative work resulted in criminal charges leading to convictions against two individuals involved in bank fraud and one administrative action of a Board employee. Fines and restitution resulting from our cases totaled \$1,890,679.

For the 2006-07 budget period, the OIG's 2006-07 budget request totals \$10,237,480, which represents a total increase of \$1,704,275 over the two-year period, or about 9.5 percent annually. As discussed below, this budget represents an increased level of effort, largely driven by legislative requirements; goals and objectives that the Board has outlined in its strategic and biennial performance plans; and ongoing investments to attract and retain our human capital. During 2006 and 2007, we anticipate that the scope and breadth of our work will grow as we address new or expanding Board initiatives related to three key legislative mandates: the

Federal Information Security Management Act (FISMA), the USA Patriot Act, and the Sarbanes Oxley Act of 2002 (SOX). Each of these areas and their corresponding impact on OIG staff requirements is summarized below:

- **FISMA Implementation:** Pursuant to FISMA, the OIG conducts an annual independent evaluation of the Board's information security program and practices, including security controls and techniques for a representative sample of information systems used or operated by or on behalf of the Board. To the extent that the Reserve Banks or other third parties collect or maintain information and use or operate information systems on behalf of the Board, their information and information systems are subject to FISMA compliance and to OIG review. As of September 2005, the Board reported a FISMA-related inventory of about 160 systems, of which about fifty percent were operated by the Reserve Banks in carrying out their delegated supervision and regulation function on behalf of the Board. These inventory numbers may grow as the Board reviews its inventory consistent with new and more comprehensive FISMA-related guidance. Current OIG staffing allowed us to review only four of the 160 systems in 2005, or about 2.5 percent of the inventory. The OIG budget request two additional staff to provide more complete, risk-focused coverage of the FISMA inventory.
- **External Oversight Function:** Pursuant to the Board's regulations implementing the USA Patriot Act, the OIG serves as the "External Oversight Function" (EOF) and is responsible for conducting a continuing review and evaluation of the Board's newly trained and allocated security law enforcement officers and the Board related programs and operations. The OIG budget anticipates performing this work with existing resources.
- **SOX Implementation.** Section 404 of SOX requires publicly-registered companies and their external auditors to report on the effectiveness of the company's internal controls over financial reporting. The Board's decision to voluntarily follow the applicable requirements of Section 404 of the SOX Act, to include having an oversight role for SOX implementation at the Reserve Banks, brings both opportunities and challenges to the OIG's workload. The OIG's organizational independence, knowledge of Board programs and operations, expertise in internal controls and risk management, and annual financial statement audits and internal control work gives us the unique opportunity to expeditiously perform SOX-related audits and attestations that our external financial auditor can rely upon, typically at a far lower cost than an external firm. For example, the blended hourly rate of an external firm performing SOX work is about \$230; in contrast, the OIG can perform the same work for a blended hourly rate of about \$55, or nearly seventy-five percent lower than that of the external firm. The OIG budget requests two additional audit staff to perform SOX-related work, funds for SOX-related training, and funds for SOX-related contracts. It also includes additional contract funds for financial statement audits, recognizing that the OIG will recompete the financial statement contract for 2006 and beyond.

The OIG's 2006-07 budget also provides for one administrative staff to provide clerical, office automation, and administrative back-up support, bringing our total administrative staffing level to two positions. While our investigative workload will likely grow over the budget period, we will attempt to address these demands with recent hires and technology enhancements.

Clearly, personnel costs are the primary driver in the OIG's budget. Our total personnel services increase of 9.1 percent provides full funding for five new positions, bringing our staffing level to thirty-six positions. However, simply continuing with on-going business using our current staffing complement of 31 positions would result in a 6.4 percent annual increase in personnel services, after considering the full two-year cost of two positions added during the current budget period, as well as the Board-approved funding for merit increases, cash awards, and variable pay to help us remain competitive in attracting and retaining a skilled workforce. To the extent possible, the OIG has attempted to self-fund the five additional positions by using salary lapse; allowing zero growth in travel expenses, supplies, and miscellaneous expenses; and decreasing operating funds in software, furniture and equipment, books and subscriptions, depreciation, and the IRM user charge. As noted earlier in our discussion of SOX, the contractual professional services and tuition categories are the only goods and services accounts that will increase over the two-year budget period, resulting in a net increase in goods and services of about 250,000, or 12.8 percent annually. Our capital budget totals \$6,800, a decrease of \$23,700, or -52.8 percent annually. In total, we are projecting a total annual budget increase of 9.5 percent. Absent the cost of SOX implementation, we estimate that the OIG's budget request would have been approximately 8 percent per year of the upcoming biennium.

To help put the 2006-07 budget in perspective, the table that follows provides a historical comparison of the OIG's operating budget relative to that of the Board over the last ten years.

**Operating Budget Comparison: OIG and Board
1996-07 through 2006-07 (projected)**

| Two-Year Period | OIG Budget | Board Budget | OIG Staff | Board Staff | OIG % Budget | OIG % Staff |
|----------------------------|-----------------------|-------------------------|----------------------|------------------------|-------------------------|------------------------|
| 1996 / 1997 | \$6,000,046 | \$326,693,918 | 32 | 1,746 | 1.84% | 1.83% |
| 1998 / 1999 | \$6,419,000 | \$352,255,000 | 29 | 1,711 | 1.82% | 1.69% |
| 2000 / 2001 | \$6,617,000 | \$389,758,000 | 29 | 1,699 | 1.70% | 1.71% |
| 2002 / 2003 | \$7,757,000 | \$465,988,000 | 29 | 1,884 | 1.66% | 1.54% |
| 2004 / 2005 | \$8,533,000 | \$527,809,000 | 31 | 1,948 | 1.62% | 1.59% |
| 2006 / 2007 | \$10,237,480 | \$609,500,000 | 36 | 1,976 | 1.68% | 1.82% |

As shown in the table, the OIG's staffing level declined by three positions in the 1998-99 budget and remained constant at twenty-nine positions over a six-year period. Even with the position increases in the 2006-07 period, the OIG's staffing levels as a percentage of the Board returns to 1.82 percent—essentially the same percentage that we had back in the 1996-97 budget. In total, the OIG's 2006-07 budget and staffing levels remains at less than two percent of the Board's projected budget and staffing levels.

We recognize that changing events may lead to supplemental budget requests that we cannot estimate at this time. For example, SOX implementation may require increases or decreases in the anticipated level of contractual professional services or the level of OIG work related to SOX implementation may exceed preliminary budget estimates. Like the Board, the

OIG also faces uncertainties about other legislative requests and mandates which may require unanticipated work. Additionally, a significant number of bank failures could trigger our mandated material loss reviews. While we generally suspend other work to perform these reviews, this approach may not be feasible should we receive a number of relatively concurrent failures coupled with continued congressional and legislated requests. Finally, the Federal Bureau of Investigation (FBI) continues to focus its work on homeland security issues and is increasingly looking to the IG community to perform investigative work that was previously performed by the FBI. Our workload has already increased during the current budget period and we will inform the Board if this work further impacts our operations.