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REPORT TO THE VICE CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

72-0226

Improvements Needed In The Federal Reserve Reporting System For Recognized Dealers In Government Securities B-169905

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

OCT. 6, 1971

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-169905

Dear Mr. Vice Chairman:

This is our report on the improvements needed in the Federal Reserve reporting system for recognized dealers in Government securities. Our review was made pursuant to your request of May 1970.

As agreed, we discussed our report with officials of the Federal Reserve Bank of New York. Although they agreed with our findings, they felt that formal comments should come from the Informal Treasury-Federal Reserve Steering Committee which has overall responsibility for the reporting system.

We plan to make no further distribution of this report unless copies are specifically requested, and then we shall make distribution only after your agreement has been obtained or public announcement has been made by you concerning the contents of the report.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

The Honorable Wright Patman
Vice Chairman, Joint Economic
Committee
Congress of the United States

COMPTROLLER GENERAL'S REPORT TO THE VICE CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

IMPROVEMENTS NEEDED IN THE FEDERAL RESERVE REPORTING SYSTEM FOR RECOGNIZED DEALERS IN GOVERNMENT SECURITIES
B-169905

D I G E S T

WHY THE REVIEW WAS MADE

p. 1786

The Federal Reserve Bank of New York operates a voluntary reporting system to accumulate statistical and financial data on the activities of private dealers in Government securities.

Participating dealers report statistical data daily and financial data annually. In 1970 the total transactions reported were $738 billion, or more than three times the value of transactions on the New York Stock Exchange.

At the request of the then Chairman of the Joint Economic Committee, the General Accounting Office (GAO) reviewed the reporting system to determine whether

--good accounting practices were being followed in preparing the reports and

--the reporting system afforded the Committee and the public with an accurate picture of the operations and profits of the dealers as a group.

GAO examined into the procedures and methods of report preparation employed by six of the 20 dealers in Government securities recognized by the Federal Reserve System.

FINDINGS AND CONCLUSIONS

The daily statistical information furnished by the dealers was reasonably reliable. This information is published regularly for the use of Government officials, financial analysts, and the public. (See p. 18.) GAO does not believe, however, that financial data which is reported annually can be relied upon because

--sound accounting methods were not followed consistently,

--numerous errors were made, and

--different accounting bases were used by the dealers in preparing the reports.

OCT. 6, 1971

The Federal Reserve Bank of New York made reviews of the reported data; however, these reviews were not effective in ensuring that the information was reliable. (See pp. 9 to 17.)

As a result of errors and inconsistencies, the annual financial data is not published and little use is made of it. (See p. 24.)

RECOMMENDATIONS OR SUGGESTIONS

The reporting system functioning as it does on a voluntary basis is a commendatory achievement. Substantial improvement in the accuracy of the annual financial reports, however, could be made by correcting some of the problems which GAO found. (See pp. 26 to 28.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

Officials of the Federal Reserve Bank of New York told GAO that, although they agreed with GAO's findings and conclusions, the Informal Treasury-Federal Reserve Steering Committee which has overall responsibility for the reporting system would have to decide what corrective action would be taken. (See p. 28.)

MATTERS FOR CONSIDERATION BY THE VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

This report outlines some measures that the Federal Reserve System could take to correct the inadequacies in the reporting systems. GAO is including these measures for such action as the Vice Chairman may deem appropriate.

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GLOSSARY

Accrual accounting	recording of financial transactions in the accounts as they actually take place (that is, as goods and services are purchased or used and as revenues are earned) even though the cash involved in such transactions is paid or received at other dates
Borrowings	funds borrowed to maintain positions
Cash accounting	recording of financial transactions only at the time that cash is received or paid for goods and services
Commitment basis	recording of securities transactions in the accounts on the date agreement to purchase or sell is made
Delivered basis	recording of securities transactions in the accounts on the actual date the securities are delivered
Margin requirements	difference between market value and the maximum loan value of securities
Market value	estimated selling or purchase price of security based on bid and ask quote of dealer
Position	the total value of the securities that a dealer holds for resale
Recognized dealers	Government security dealers who--the Federal Reserve Bank of New York considers--have established a satisfactory financial credit standing and can handle a large volume of trading and accordingly are permitted to deal directly with the trading desk

Repurchase agreement	arrangement for borrowing money whereby securities are "sold" by the dealer with a commitment to buy identical securities back at a specific price
Settlement basis	recording securities transactions on the date agreed upon for delivery of the securities
System open market account	the Government securities held by the Federal Reserve System
Trading desk	the personnel who buy and sell securities for the Federal Reserve Bank of New York
Transactions	purchase or sale of securities

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CHAPTER 1

INTRODUCTION

In May 1970 the Chairman of the Joint Economic Committee requested that the Comptroller General look into the reporting system established by the Federal Reserve System for dealers in Government securities and advise him as to whether the reporting system was likely to afford the public and the Joint Economic Committee an accurate picture of the operations and profits of these dealers as a group and whether the accounting practices used in reporting were in accord with good accounting standards. A copy of the Chairman's request is included as appendix I.

BACKGROUND

The Federal Reserve System, among its other functions, is responsible under the Federal Reserve Act for maintaining a flow of credit and money that will foster orderly economic growth and a stable dollar. This function is, in part, accomplished through the public sale and purchase of Government securities (U.S. Government and Federal agency securities).

To carry out this function, the Federal Open Market Committee of the Federal Reserve System has the responsibility of determining the policy to be followed in the purchase and sale of Government securities. The objective of the Federal Open Market Committee is to protect the monetary machinery from undue stress and to influence the economy by affecting the cost and availability of credit.

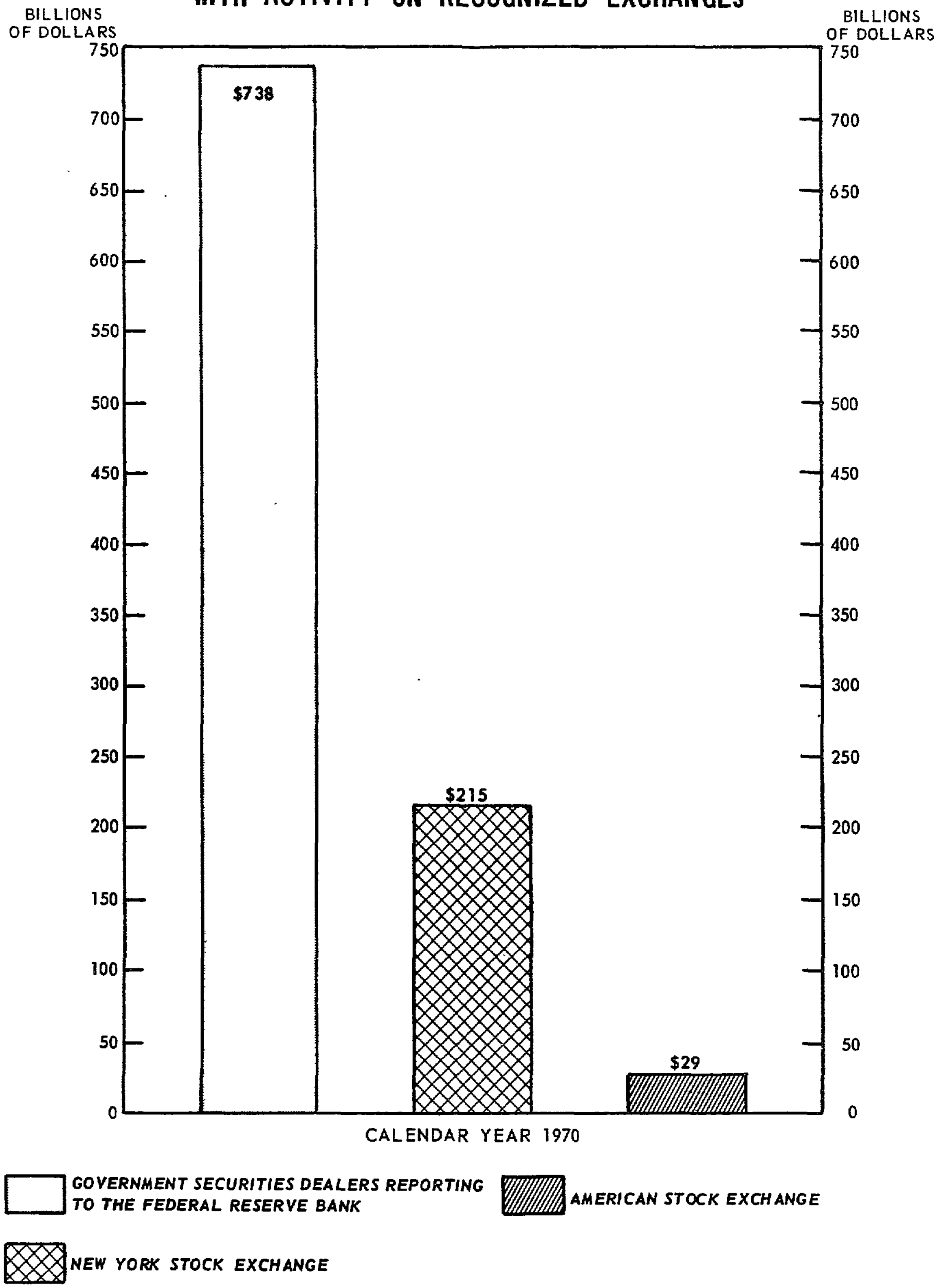
The Federal Open Market Committee has delegated the responsibility for executing its policy for all Reserve banks to the Federal Reserve Bank of New York (Federal Reserve Bank). Each year the Federal Open Market Committee appoints a senior officer of the Federal Reserve Bank to manage the system open market account. The manager maintains a trading desk at the Federal Reserve Bank to handle all purchases and sales of Government securities.

Marketable Government securities are traded daily in an over-the-counter market by dealers in Government securities. Certain dealers, called recognized dealers, are permitted by the manager of the system open market account to trade directly with the trading desk and are expected to respond to the trading desk's needs for buying and selling these securities. This procedure is designed to ensure that dealers admitted to trading have the resources and ability to undertake large volumes of trading.

The number of recognized dealers varies from year to year. As of March 31, 1971, there were 20 recognized dealers, of which 11 were nonbank business enterprises and nine were banks. They form a security market which is the largest in the country in terms of dollar volume and which is heavily vested with the public interest. The market is not regulated by either the Government or a private association.

The volume of purchases and sales by recognized dealers in Government securities increased steadily from $573 billion in 1966 to $738 billion in 1970. A comparison of the 1970 volume of Government securities traded with purchases and sales of the New York Stock Exchange and the American Stock Exchange is shown in the following chart.

TRANSACTIONS REPORTED BY GOVERNMENT SECURITIES DEALERS COMPARED WITH ACTIVITY ON RECOGNIZED EXCHANGES



Because statistical and financial information about the dealer market was scarce, a formal reporting system was established in 1960. The reporting program was aimed at providing current information on the functioning of the market in Government securities to the public, to students of the market, and to market participants, including the Federal Reserve System and the Treasury Department. Reports include, in addition to annual reporting of balance sheet and income data, daily statistics covering securities positions and borrowings and volumes of transactions. No legal or regulatory requirements exist to enforce reporting; the dealers have reported voluntarily.

NATURE OF GAO REVIEW

Our work was done at the Federal Reserve Bank and at business offices of six dealers in Government securities located in New York. The dealers included in our review were selected with a view toward obtaining representation from each of the three types of dealers which are categorized as specialist, bank, and multioperation.

In the case of financial reporting, we reviewed the requirements imposed on dealers by the Federal Reserve Bank instructions. At each dealer's office we obtained reports submitted to the Federal Reserve Bank for the year ended December 31, 1969. We determined whether the figures on these reports were taken from the dealers' books of account or financial statements or whether the amounts in the accounts or statements had to be revised to satisfy Federal Reserve Bank instructions.

In those instances in which revised figures had been reported to the Federal Reserve Bank, we identified the procedures and methods used to make the changes. We reviewed some of these adjustments, calculations, and other transactions to determine whether sound accounting principles and practices were followed and whether the results were reasonably accurate.

For the daily reports, we reviewed the detailed procedures followed by the six dealers to accumulate, record, and report information required by the Federal Reserve Bank. We selected a few transactions and traced them through the dealers' systems to determine whether the transactions had been handled in accordance with dealer procedures, sound trade practices, and Federal Reserve Bank instructions. We observed the preparation of daily reports for one day at each dealer's office and traced the information through the Federal Reserve Bank processes into its computer file.

Our work was done principally through discussions with the Federal Reserve Bank and dealer officials; onsite observations of operations; and reviews of a limited number of transactions, accounting records, and other data. The cooperation and courtesies extended to us by the Federal Reserve Bank and dealers were excellent.

Our review did not cover the activities of the System Open Market Account.

The confidential nature of the data relative to operations of individual dealers was maintained in accordance with rule 23 of the Joint Economic Committee which places limitations on the disclosure of data obtained from individual dealers.

CHAPTER 2

FINANCIAL REPORTS

We found that the financial reports submitted by the dealers had not been prepared in accordance with sound accounting methods. Further, the dealers used different bases in preparing the reports and made substantial errors in compiling the information in the reports. Consequently we have little confidence that these reports provide accurate information on the operations and profits of the dealers as a group. A list of the deficiencies in the reports we examined is included as appendix II.

The deficiencies in the reports we examined occurred primarily because the dealers did not use sufficient care in preparation of the reports and because the Federal Reserve Bank reviews failed to detect them. The inconsistencies in the data contained in reports prepared by the participating dealers are attributable to the wide latitude in reporting practices permitted under the Federal Reserve Bank instructions.

Before describing some of the major deficiencies affecting the reliability of the reports, it is important to mention the factors that complicate dealer reporting. The Federal Reserve Bank instructions provide for submission of reports on a calendar-year basis, whereas seven out of 20 dealers operate their accounting systems on a fiscal-year basis. Their closing of accounts can be at different dates during the calendar year. Thus their normal year-end adjustments are not made for the period covered by the Federal Reserve Bank reports.

Also 14 are engaged in activities other than trading in Government securities and their accounting systems and normal financial statements relate to the entire operations. As a result of both these factors, many adjustments had to be made to the information in their formal accounts to prepare the Federal Reserve Bank reports. It is in this conversion process that most of the problems existed.

INCOME

We found two major problems which affected income--namely, all trading gains or losses were not reported in the right reporting period, and dealers used different methods to calculate unrealized gains or losses.

All gains and losses not reported in the right reporting period

The dealers included in our review used three methods of recording security transactions (1) the commitment basis, recording transactions on the date that the purchase or sale is made, (2) the settlement basis, recording transactions on the agreed-upon date for delivery, and (3) the delivered basis, reporting transactions on the actual date that the securities are delivered. For 1969 the Federal Reserve Bank required dealers to report on a commitment basis in their income statements all unrealized gains or losses on positions as of December 31.

Included in our review were three dealers who were on other than a commitment basis and who did not make the necessary adjustments for reporting. Thus one dealer reported unrealized gains and losses on $649 million of securities but did not report in that reporting period unrealized gains and losses on an additional $330 million of securities that should have been included in his computation if it were made on a commitment basis.

The second dealer, with a position of $313 million, omitted from his computation about $44 million of securities; the third omitted $6 million from his calculation on $54 million of position. In addition, these same dealers did not compute the realized gains or losses on securities which were purchased and sold prior to January 1 but which were not settled until after December 31.

Although the dealers knew that they were required to report on the commitment basis, they did not do so because they said that too much effort was required. The dealers did not provide us with data on what the cost of reporting on the commitment basis would be and we did not make our own study of such costs; however, we believe, with proper planning, the report could be prepared on the commitment basis without an unreasonable amount of effort.

Early in our study, we advised the Federal Reserve Bank of our findings regarding the use of other than the commitment basis of reporting. On their own initiative, bank officials revised the instructions to permit dealers to compute profits on their own accounting bases. We doubt the merits of this revision because it could have a material effect on the reported gains or losses. This would occur when there are large variances in opening and closing positions on a commitment basis which would not be reflected by the dealer's accounting basis.

Further, in the case of interdealer trading, there could be significant transactions lost to the reporting system. For example, if a dealer reporting on the commitment basis sold securities on December 31 to another dealer reporting on the settlement method, these securities would not be reported in the positions of either dealer.

Different methods used to calculate unrealized gains and losses

The Federal Reserve Bank also instructs the dealers to compute their unrealized gains or losses on year-end positions at market value and allows the dealers to choose their own methods of determining market values.

The dealers whose records we reviewed used four methods of determining market values for their positions. Three dealers used their own judgment of prices. One used published composite prices; one used last sale; and one dealer used a combination of his own judgment and price quotes of another dealer. Thus the same class of securities held by each dealer may be valued at different prices for computing unrealized gains or losses.

When we advised the Federal Reserve Bank of this problem, they again issued new instructions requesting dealers to use the Federal Reserve Bank composite closing quotations. This, however, did not fully resolve the problem because closing quotations only include securities issued by the Treasury and do not include securities issued by other Government agencies. Agency securities can represent significant sums. For example, one dealer's position included $121 million in Government agency securities.

EXPENSES

The major problems in reporting expenses were the numerous errors made by dealers in allocating them and the different methods of accounting for them.

Questionable allocations

The Federal Reserve Bank instructs dealers to allocate expenses between their Government operation and other operations. The five dealers who had to make allocations attempted to comply with instructions; however, they did not follow sound accounting practices or were not careful in making distributions.

In pooling their expenses for allocation, some dealers did not follow the accepted practice that there must be some relationship between the expenses and the operation to which they are allocated. For example, one dealer overstated his reported expenses by about $900,000 because his pool included commissions and dividends not related to Government operations and interest on partnership capital, which is not an expense but a form of profit distribution. Another dealer did not reduce his reported expenses by $84,000 because he did not allocate to other operations the cost of services performed for those other operations by his Government operations.

Also Government securities are used to borrow funds for all of the dealers' operations. In allocating the related interest expense, two dealers charged their Government operations with the total interest on borrowings made with Government securities without regard to how much was relatable to non-Government operations. Since interest on borrowed funds is the dealers' largest expense, this could have a material impact on reported net income. To illustrate the impact that this allocation can have when done properly, one dealer who did allocate such interest costs, instead of reporting all of it under Government operations, showed only $8.1 million out of a total of $10.3 million as relatable to Government operations.

In addition, dealers used various bases for making allocations. One dealer arbitrarily allocated administrative expenses on the basis of the number of people employed in Government operations to the total number employed and did not establish that this ratio was commensurate with the benefits obtained by the Government activities. Another dealer merely had his staff estimate the amount of expenses to be allocated to Government operations without any supportable basis except judgment.

<u>Different methods of accounting used in reporting</u>

The Federal Reserve Bank instructions are silent as to whether reports should be prepared on an accrual or cash basis; this is one of the reasons for the lack of uniformity in reporting. Three dealers prepared their statements on an accrual basis and three dealers submitted their statements on a combination of accrual and cash basis. For example, one dealer reported interest earned, prepaid insurance, and interest on borrowed funds on an accrual basis but reported general and administrative expenses on a cash basis. We did not make a study to determine the difference in profit and loss that would result from the use of the accrual basis for general and administrative expenses; however, in view of the size of such expenses, we believe the difference could be substantial.

<u>Other</u>

The following paragraphs illustrate other questionable methods employed by dealers in the preparation of financial reports.

Some dealers' Government securities positions were financed with funds borrowed from their other operations. The Federal Reserve Bank requires these dealers to apportion a part of these funds as interest free because they represent allocated capital. Interest is includable on the remaining portion as part of reportable expenses.

One dealer has been using an estimated amount of $7.5 million since 1965 to represent his allocated and therefore interest-free capital and has been reporting the interest on the remainder as expense. We were told that this $7.5 million estimate was based on a comparison of the relationship between capital and total Government positions of several other New York City dealers. We believe that more exact methods of determining allocated capital should have been employed.

Another dealer made no allocation in 1969 and reported interest expense on the total borrowings. He reported interest-free borrowings in 1965 of $5 million. Assuming the same apportionment for 1969, the reported interest costs for borrowed funds would have been reduced by about $429,000.

The dealers told us that they could not make a realistic apportionment unless the Federal Reserve Bank gave them more guidance. These same dealers, in computing interest on funds borrowed to finance Treasury bill positions, used par value of the securities as a base rather than the amount borrowed. In addition, one of these dealers used the wrong interest rate to make the calculations. As a result, the interest expense reported by one dealer was $175,000 too high whereas the other reported a figure that should have been $9,000 higher.

Also, the Federal Reserve Bank instructs dealers to report profits both before and after income taxes and specifically states that income taxes are not to be included as an expense. We found that three dealers reported correctly. One of the remaining three dealers included the New York City income tax as an expense, and two dealers ignored the city tax altogether in preparing their reports.

NET WORTH ALLOCATION

The Federal Reserve Bank requires nonbank dealers to estimate net worth allocable to Government activities for use in its profit studies on return on capital. The methods used for allocation did not appear to provide reasonable results because the Federal Reserve Bank has not given dealers suitable guidance.

A Federal Reserve Bank study in 1967 indicated that it was aware that dealers were having problems and were using various methods to allocate net worth. The report also discusses various concepts of net worth allocation and the difficulties encountered in applying them. It was silent, however, as to which method would be preferable or what guidelines should be followed.

The dealers are apparently still having problems in complying with this requirement and are still using various methods in preparing the reports. In some instances the results appeared questionable. The following examples illustrate some of these conditions.

In determining the amount of net worth used for his position in Government securities, one dealer included $4 million of Government securities held for his own investment purposes plus $2 million of Government securities deposited with clearing corporations for handling other than Government transactions. The $6 million should have been treated as applying to his other operations since these funds were not used in maintaining his position.

Another dealer using a ratio of positions to all company assets reported a net worth allocation to Government operations of $2.4 million. This dealer did not retain the details of his calculations. We used the method he described in his report to the Federal Reserve Bank to compute an allocation of $1.9 million as applicable to Government operations, or $500,000 less than reported. Although the dealer agreed with our computation, he was unable to determine what caused the difference.

In allocating net worth, a third dealer used a ratio of Government securities to his total position. This method appears inequitable because considerably less of the company's own capital is needed to maintain Government securities positions since

--large positions of Government securities need less borrowings owing to their margin requirements which range from less than 1 to less than 6 percent, whereas 25 percent margin is necessary on corporate bonds and 65 percent for stocks and

--the low amount of positions kept by the dealer's underwriting activities (which handles other than Government issues) required substantial resources to operate.

Under such circumstances, a disproportionate amount of net worth can be allocated to the Government securities operation.

REVIEW OF FINANCIAL STATEMENTS

The Federal Reserve Bank reviews of dealer reports were not effective in ensuring that the reported financial data was reasonably reliable because the group responsible for such reviews did not

--visit dealers to examine the supporting data and review report preparation practices,

--have staff with professional accounting expertise, and

--have the authority required to obtain dealer cooperation.

Among its other duties, the Market Statistics Division of the Federal Reserve Bank is responsible for processing, reviewing, and distributing dealer reports. Its reviews consisted essentially of checks for mathematical accuracy, completeness, and consistency with other reports. They told us that they also made certain analyses of the financial data but did not rely too heavily on them because they felt that the information was unreliable. These reviews were done at the Federal Reserve Bank. According to the Market

Statistics Division, visits were not made to the dealers' offices to examine into the reports in more depth because it did not have the authority to do so.

Another problem in making such reviews was that the Market Statistics Division did not have any professional accounting expertise on its staff. The Market Statistics Division had about 32 individuals on its staff comprising 11 professional and junior economists, 16 statistical clerks, and five typists and messengers. About eight of these staff members were assigned to processing, reviewing, and distributing the financial reports.

The Market Statistics Division had no authority to correct errors found in dealer reports or to enforce improvements in dealers' reporting practices.

If the staff of the Market Statistics Division obtained professional accounting expertise and were permitted to review dealers' accounting procedures at the site, they could more effectively identify errors and inconsistencies in the dealers' reports. They could also encourage dealers to make changes and improvements in the data reported.

CHAPTER 3

DAILY STATISTICAL REPORTS

The Federal Reserve Bank requires the dealers to submit daily the following statistical information.

Type of report	Description
Positions	The amount of securities held for trading valued at par by type of security
Borrowings	The amount borrowed to maintain positions by source and type of security
Volume	The amount of sales and purchases at par value by source and type of security

We found a marked contrast in the procedures and controls covering the processing and reporting of transaction data when compared with those used for reporting financial information. The transaction reports usually came directly from the dealers' day-to-day operating systems. The need to have up-to-date and accurate data for trading operations undoubtedly had an influence on the reliability of those systems.

Although we found that two dealers had reported certain repurchase agreements incorrectly, the Federal Reserve Bank told us that in two instances the incorrect data had not materially affected the data as a whole and in another the Federal Reserve Bank had issued corrected instructions for future reporting. On the basis of our observations, it seems that the dealers have adequate internal control procedures for processing daily transactions. Accordingly we believe that the information furnished to the Federal Reserve Bank in the aggregate is reasonably reliable.

The following paragraphs illustrate the errors found.

The Federal Reserve Bank and the dealers regard repurchase agreements as loans secured with collateral. The then-current instructions required that repurchase agreements be reported as borrowings at the actual amount borrowed. We found that two dealers were valuing their outstanding repurchase agreements at par value of the securities pledged as collateral instead of at the amount of funds borrowed. As a result, these dealers were overstating from 3 to 4 percent the amount borrowed in the daily transaction report. Although this practice was contrary to instructions, Federal Reserve Bank officials said that they were aware that some dealers were doing this but they believed that the aggregate borrowing statistics were only slightly affected by it.

We found also that one of the dealers discussed in the preceding paragraph had, in accordance with a 1966 instruction, reported a certain type of repurchase agreement as a sale. Although the total amount was substantial, about $148.6 million, the transactions occurred rather infrequently. After discussing this situation with Federal Reserve Bank officials, they rescinded the 1966 instruction and advised the dealer to follow then-current instructions.

CHAPTER 4

OTHER OBSERVATIONS

During our review, we noticed conditions which we consider important to the subject of the review and which may be of interest to the Committee. These conditions deal with problems in analyzing net income, improved disclosure of matters that would significantly affect the reports, and the lack of use made of the financial reports.

PROBLEMS IN ANALYZING NET INCOME

Except for information relating to net profit and net worth, data permitting analysis of the profitability of market operations in Government securities was limited. This situation stemmed essentially from the Federal Reserve Bank's inability to obtain information on certain sources of income and factors affecting profits.

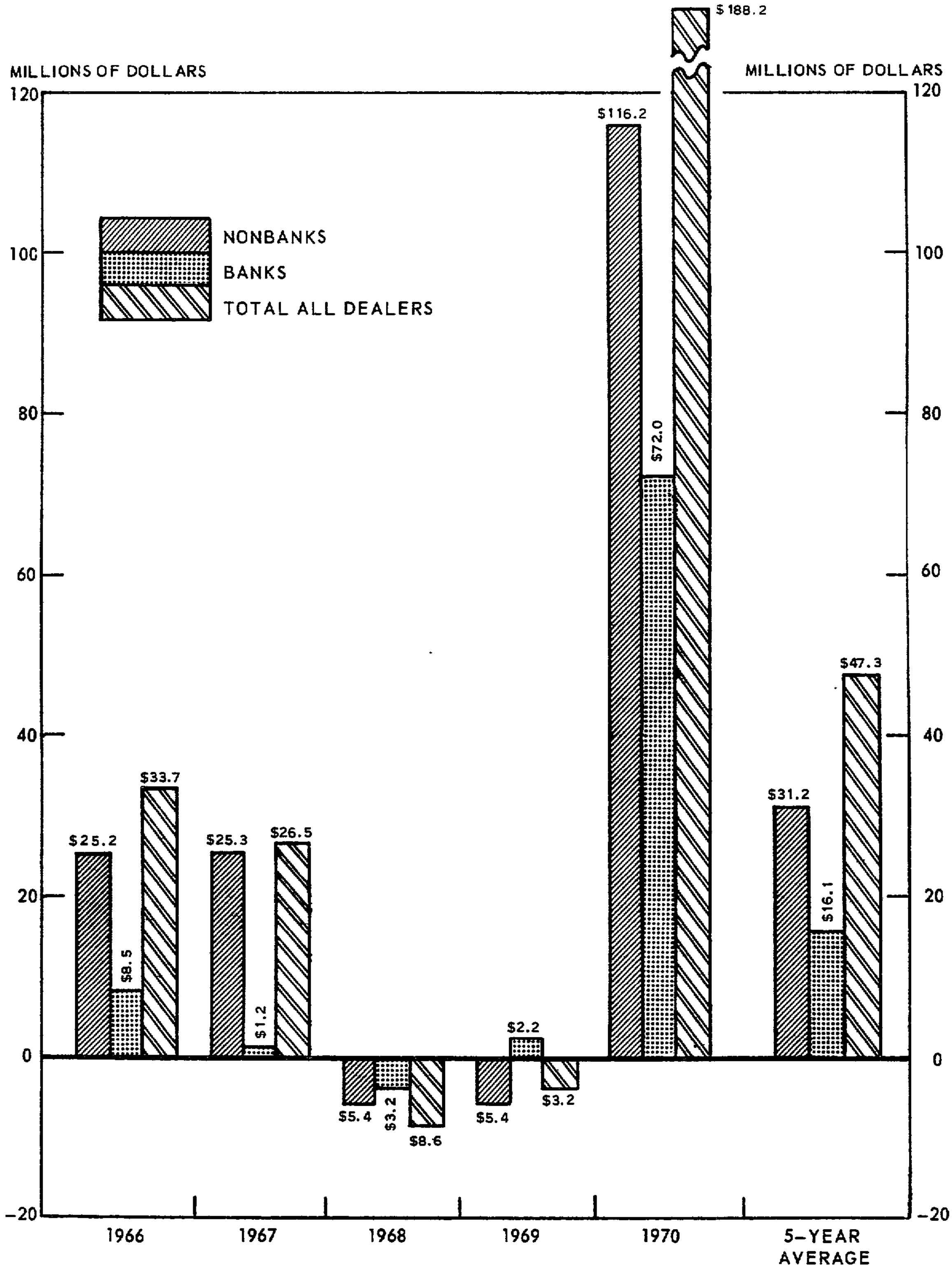
For the period 1966 through 1970, the aggregate of earnings reported by all dealers, before taxes, ranged from a loss of $8.6 million in 1968 to a net profit of $188.2 million in 1970. The chart on the following page shows the reported profits for each year and the 5-year average.

In discussing the difference in the 1969 and 1970 figures, a Federal Reserve Bank official told us:

> The sharp swing in dealer earnings between 1969 and 1970 stemmed from the turnaround in interest rates. In 1969 interest rates were rising and they reached record levels. Dealers maintained relatively small positions and had to finance them at negative yields. In 1970 interest rates declined and dealers increased their positions in anticipation of further reductions. Also the drop in short-term money market rates outpaced declining yields on long-term securities and allowed dealers to finance their positions at favorable rates. The trend toward higher prices enabled the dealers to earn substantial trading profits.

A more detailed analysis of these factors was not possible because the net income information obtained by the

DEALERS IN GOVERNMENT SECURITIES REPORTING TO THE FEDERAL RESERVE BANK OF NEW YORK DEALER PROFITS (BEFORE TAXES)



Federal Reserve Bank did not provide, in all cases, for dealers to segregate trading profits from interest earned on Treasury bills. Such information is furnished only if the dealer normally makes such a breakdown. Although bills constitute the largest volume of securities sold, three of the six dealers that we visited did not separate interest earned from trading profits but lumped these factors together. Thus the extent of trading profits in the aggregate was undeterminable.

An analyst of the Federal Reserve Bank stated that another important factor influencing profits was the interest paid on funds borrowed by the dealers to finance their positions. We noted that in 1970 the Federal Reserve Bank entered into about $34 billion worth of repurchase agreements with nonbank dealers. The Federal Reserve Bank enters into these transactions in performing its function of maintaining a flow of credit and money. The interest rate paid by the dealers on these borrowings is almost always less than if they obtained the funds from other sources.

For example, during July 1970, the Federal Reserve rate was as much as 2 percent less than the New York City bank loan rates for dealers. Thus these transactions enable dealers to finance their securities at lower costs. Financial data that would readily allow assessment of these transactions on nonbank profits is unavailable.

The rate of return reported on net worth by the nonbank dealers for the 5-year period is shown below.

Rate of Return on
Net Worth Allocated to
Government Securities Operations

Year	Net income (millions)	Net worth (millions)	Percentage of return
1966	$ 25	$ 76	33
1967	25	97	26
1968	-5	101	-5
1969	-5	104	-5
1970	116	129	90
5-year average	31	102	31

We obtained profit and net worth data on the profitability of other industries and operations. The First National City Bank of New York monthly economic letter of July 1971 showed composite rates of return on net worth, after taxes, for more than 3,700 leading corporations. These included manufacturing, transportation, and financial institutions (commercial banks, investment trusts, etc.). To put the economic letter figures on the same basis as those of the dealers, we adjusted the profits, after taxes, to arrive at profits, before taxes, by assuming a tax rate of 50 percent. The economic letter figures as adjusted are shown below.

	Percent of return on net worth	
	1969	1970
Manufacturing	25	20
Transportation	8	2
Financial	12	13
Composite	21	18

We also obtained from the New York Stock Exchange reported statistics covering the financial results of member firms. This information showed that more than 300 firms made a return on net worth, before taxes, of 16 percent in 1969 and 19 percent in 1970.

A General Accounting Office profit study showed that, for 74 large defense contractors in 1969, the average return on net worth, before taxes, was 17.4 percent on work for the Department of Defense, 24.8 percent on work for other defense agencies and 20.4 percent on commercial work.[1]

These figures are shown not for the purpose of assessing the reasonableness of earnings by the dealers but merely to provide some information on how they compare with other business enterprises in the economy.

[1]Defense Industry Profit Study, B-159896, March 17, 1971.

NEED FOR REFINING FINANCIAL REPORTS

In addition to the incomplete disclosure of income data, we observed:

1. Federal Reserve Bank instructions did not require assertions to the effect that financial statements were or were not prepared on a basis consistent with that of the preceding year. In our opinion, such an assertion should be required to disclose any accounting procedural changes that would produce results differing materially from past years.

2. Some dealers adjusted their security positions each month to market values and record the unrealized gains or losses in the income accounts. Under these circumstances, the more acceptable method of financial data presentation requires that disclosure be made of the amount of unrealized profit which accumulated over the year and is still in the position values at year-end. Such disclosure is not specifically required by the Federal Reserve Bank.

USE MADE OF REPORTS

The expressed doubts about the reliability of the financial reports have limited their usefulness. We understand that the daily reports were meaningful to officials of the Federal Reserve Bank.

Financial reports

We found practically no use made of the financial reports and therefore discussed this matter with officials of the Federal Reserve Bank, the Federal Reserve Board, and the Treasury Department. Some of their comments follow.

An official of the trading desk, Federal Reserve Bank, told us that the financial reports were not necessary to its operation. Such information, however, could be useful to observe broad trends in the market if it were not for the problems in allocating income, expense, and net worth.

A Federal Reserve Board staff member stated that the reports were used for (1) identifying changes in dealer operations, (2) evaluating dealer profits, and (3) determining those dealers that may have financial difficulties. He added that the reports would be more useful if the allocation methods for expenses and net worth were improved.

Treasury officials were concerned with whether there were enough dealers to handle the volume of trading and were also interested in such other matters as dealer profits. They believed that the reports were necessary but that they could be more useful if improved.

We also found that the financial data, in the aggregate, was not regularly distributed to the Congress or to the public. An official of the Federal Reserve Bank told us that this was not done because the reports were considered unreliable and therefore meaningless.

Daily reports

Each day the trading desk at the Federal Reserve Bank receives position data for each dealer and aggregate data on positions, dealer borrowings, and volume of transactions to assist it in its open market operations. In addition, selected data in the aggregate is sent daily to all the Federal Reserve Bank presidents, to the Federal Reserve Board, and to the Treasury Department.

Only aggregate statistics are released to the public through weekly press releases and the monthly Federal Reserve Bulletin. The volume of transactions is publicly released weekly and position and borrowings after a 4-week time lag.

Federal Reserve Bank officials who operate the trading desk have told us that the data is useful for several purposes. The data is used to determine the amount of securities available for purchase from dealers and to determine the amount of money borrowed and the source of borrowings.

CHAPTER 5

SUGGESTED CORRECTIVE MEASURES

Considering the highly sensitive nature of the Government security market operation and how little was known about it in 1960, we believe that the progress made toward developing and operating a financial and transaction reporting system merits commendation. The fact that this progress was made without regulations and achieved through the Federal Reserve Bank and dealer cooperation also warrants recognition.

Even so, we believe that our findings show a need for the Federal Reserve Bank and dealers to improve the reliability and usefulness of the financial data accumulated under the reporting system. This will require special effort by them if improvement is to be achieved. In the remainder of this chapter, we are suggesting some corrective measures that we believe could be taken by the Federal Reserve System to achieve appropriate improvements.

STRENGTHENING CONTROLS OVER PREPARATION OF REPORTS

In chapter 2 we pointed out major problems that were encountered: (1) all income was not being reported for the accounting period because some dealers were not on a commitment basis and (2) some dealers reported some accounts on an accrual basis but reported others on a cash basis. It is generally recognized that the accrual method of accounting more accurately shows the financial position of a concern and more precisely measures the results of operations for specific periods. Accordingly we believe that the financial reports should be prepared on an accrual basis if a significant difference might result.

Another problem discussed in chapter 2 was the reasonableness of expenses allocated to the Government securities operation. The inequities found were mostly attributable to mistakes made by the dealers and the need for more specific guidance by the Federal Reserve Bank. We believe that the following steps could be taken by the Federal

Reserve System to build a greater degree of assurance into the reporting system.

--Develop criteria for the dealers to follow in allocating expenses with special emphasis on the suitability of the basis used to allocate costs and the relationship of expenses to Government securities operations.

--Require dealers to retain the working papers supporting such items as adjustments, allocations, and calculations in preparing reports so that questions involving the data submitted can be properly resolved.

--Establish methods for increasing awareness on the part of top management officials of the dealers that complete and accurate data is to be provided.

--Establish and require dealers to use uniform quotations to determine market value of Government agency securities.

Chapter 2 also covers the question of obtaining realistic allocations of net worth which has been a continuing problem. Essentially there is a lack of guidance in this area. We believe that problems in such allocations could be overcome through the development of specific criteria on the method to be used in allocating net worth.

IMPROVING REVIEW FUNCTION

To strengthen the Federal Reserve Bank review function we believe that

--the Market Statistics Division should obtain professional accounting expertise,

--the review procedures of the Market Statistics Division should be modified to provide for examinations of financial data and supporting workpapers at the dealers' offices, and

--the authority of the Market Statistics Division could be broadened to provide for visits to dealers' offices and enable it to make changes necessary to improve the accuracy and usefulness of financial reports.

REFINE FINANCIAL REPORTS

In chapter 4, we show the advantages that can be gained by refining the financial reports particularly with respect to more complete disclosure of income data. The following steps could be taken to provide for better reporting.

--Require dealers to segregate Treasury bill trading profits from interest earned in the net income analysis.

--Require dealers to indicate whether reports were prepared on a basis consistent with that of the prior year. If changes in accounting procedures were made, the dealer should describe the nature of the change and the effect on the data.

--Require dealers to disclose the unrealized gains and losses for all Government securities using cost as a base. The balance sheet should show the amount of unrealized gain or loss included in reported positions.

DISTRIBUTION OF AGGREGATE REPORT DATA

To ensure distribution of financial data to the Congress and the public, we believe that consideration should be given to inclusion of the dealers' aggregate data in the annual report of the Federal Reserve Board. To accomplish this, we suggest that the Federal Reserve Bank establish reporting dates to coordinate with the date of the annual report.

AGENCY COMMENTS

We discussed the report with officials of the Federal Reserve Bank who gave us their informal comments. Although they agreed with our findings and conclusions, they told us that the Informal Treasury-Federal Reserve Steering Committee, which has overall responsibility for the reporting system, would have to decide on what corrective action would be taken.

APPENDIXES

Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
WASHINGTON, D.C. 20510

May 1970

The Honorable Elmer B. Staats
Comptroller General of the United States
Washington, D. C.

Dear Mr. Staats:

Eleven years ago, at my request, the staff of the Joint Economic Committee developed a set of reporting forms and accounting standards to use in obtaining information on the operations of the dealers who make a market in Government securities. At that time there were seventeen such dealers. The results were published by the Committee in 1960 in a pioneering staff study of this market. Subsequently a system of regular reporting on this market was developed by the Federal Reserve System in cooperation with the dealers. This system now produces a regular flow of data about transaction in the market and on revenues, expenses, and profits of dealers, both bank and nonbank.

Now that this system has been operating for several years, it would seem appropriate to review the basic accounting standards that are employed to make sure that these are in accord with the best practices. This would insure that we could have confidence in the data, particularly as to the profits of the dealers. With this aim in view, I am attaching a set of the forms and instructions used by the Federal Reserve Bank of New York in operating this system of reporting and I request that your accounting experts go over this system and advise me as to whether or not: (1) the accounting practices are in accord with the best accounting standard; and (2) such a system is likely to afford the public and our Committee an accurate picture of the operations and profits of these dealers as a group.

Mr. James W. Knowles, Director of Research for the Joint Economic Committee, has been involved with this system from the beginning in 1959, and is available to work with you in any way needed in the course of your review.

Sincerely,

Wright Patman

Wright Patman, Chairman

LIST OF FINANCIAL REPORT DEFICIENCIES BY TYPE AND PRIMARY CAUSE

Statements of Financial Condition

	Primary cause
1. Adjustment of securities positions from the dealer's basis of accounting to the commitment basis was made incorrectly. (2)[1]	D[2]
2. Various methods were employed for determining the market value of securities positions. (6)	F
3. Net worth allocated to Government securities activities was not adequately supported. (1)	D
4. Securities borrowed and the offsetting liability were not reported. (1)	F
5. Liability for outstanding repurchase agreements reflected par value of the securities instead of actual money borrowed. (1)	D
6. Securities purchased but not yet received understated due to a footing error. (1)	D
7. Accrued interest receivable and accrued interest payable were inaccurate. (2)	D
8. Nonreportable securities were included in financial statements. (2)	D
9. Securities sold but not yet delivered were improperly stated. (2)	D
10. Securities positions were overstated. (2)	D
11. Repurchase agreements were improperly classified as to maturity and type of security. (2)	D

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[1]See page 34.

[2]See page 35.

	Primary cause
12. All contingent liabilities were not reported. (1)	D
13. Required explanations of data were not submitted. (2)	D
14. Positions in agency securities were erroneously classified as "other securities." (1)	D
15. The reported increase in net worth was not accurate. (1)	D
16. Related asset and liability accounts were offset even though the Federal Reserve Bank instructed otherwise. (1)	D
Net Income Analysis	
17. Trading profits were not reported on the commitment basis, as required by Federal Reserve Bank instructions. (3)	D
18. Unrealized gains or losses not reported in the right reporting period. (1)	D
19. Unrealized gains on Government securities including Treasury bills were not properly classified. (1)	D
20. Unrealized loss was erroneously reported as unrealized gain. (1)	D
21. Income was not reported on a calendar-year basis as required by the Federal Reserve Bank. (1)	D
22. Certain interest income was offset against interest expense. (3)	D
23. Expenses on certain transactions were offset against interest income instead of being reported separately as required. (1)	D

	Primary cause
24. Required explanations of data were not submitted. (2)	D
25. Income on Treasury bills was overstated. (1)	D
26. All income items were not reported. (1)	D
27. Cost of borrowed funds was overstated because interest was on the par value of Treasury bills instead of the discounted value. (2)	D
28. Unrealistic interest rate used for calculating the cost of own bank funds used. (1)	D
29. Miscellaneous income items were incorrectly classified. (2)	D
30. Miscellaneous interest expense was inaccurately reported. (3)	D
31. Expenses included certain items not applicable to Government securities activities. (2)	D
32. No schedule supporting expense allocations was submitted. (1)	D
33. Interest-free dealer department capital estimate was unrealistic or not estimated. (2)	D
34. Local income taxes were treated inconsistently. (6)	F
35. Interest expense was overallocated as a result of including costs incurred in financing other than Government securities activities. (2)	D
36. Data submitted was not fully on an accrual basis. (3)	F

NOTE: Figures in parentheses ( ) indicate the number of dealer errors.

TABULATION OF DEFICIENCIES

	Number of deficiencies Type	Number of deficiencies Instances
D = caused primarily by erroneous dealer procedures.	32	51
F = caused primarily by weaknesses in Federal Reserve Bank instructions, guidelines, etc.	4	16
	36	67