

MEMORANDUM

May 24, 1985

TO: Chairman Shad

FROM: Clarence Sampson



SUBJECT: Auditing and Accounting Issues Involved in Repurchase Transactions

This is in response to your memo dated April 11, 1985 eliciting my views as to 1) whether new auditing standards are necessary to reduce the likelihood of future failures in the government securities market and 2) whether any changes in generally accepted accounting principles are necessary in the wake of these recent failures. Briefly, I believe that while auditing standards are adequate, additional educational guidance is needed. In the accounting area, I believe the FASB should add to its agenda a project to address the various accounting issues involved in the broad area of financial instruments. In addition, I believe that the Commission should propose rules to ensure full disclosure of the nature and extent of a registrant's repurchase transactions and the degree of risk involved.

Before responding more fully to your two specific questions, I should point out that the accounting issues involved in the area of repurchase transactions are far reaching and complex. Moreover, repurchase transactions are only one type of a much broader spectrum of transactions generically described as involving financial instruments. These financial instruments impact commercial companies, governmental entities and specialized industries (including financial institutions) and as evidence of the increasing complexity of these transactions, many of the issues discussed thus far at the FASB's Emerging Issues Task Force ("EITF") have dealt with the accounting for various financial transactions and instruments.

The recent failures also re-emphasized a continuing major question -- the appropriate accounting for financial institutions. I believe that ultimately a form of market value accounting for at least some assets (as opposed to the present primarily historical cost basis) is necessary to more realistically portray the economic condition of financial institutions. I recognize, however, that such a step would have major consequences and could probably only be achieved gradually.

Auditing Standards

I believe that existing auditing standards are adequate and provide appropriate guidance. This is consistent with the preliminary conclusions of the Auditing Standards Board's recently formed special task force which addressed the audit issues related to repurchase transactions. However, because some of the recent problems in this area appear to be the result of the failure to fully understand the nature and extent of the risks involved in repurchase

transactions, I also endorse the task force's recommendation that certain educational material should be added, as supplemental guidance, to currently existing industry audit guides. */ I am pleased by the AICPA's timely response in providing audit guidance which is expected to be published shortly. Interpretive guidance should also be issued by the AICPA regarding auditing related party transactions, a project which I understand is underway. Finally, I agree with the task force's conclusion that a need exists for a comprehensive study of all financial instruments that will provide guidance to auditors of parties to those instruments. Such a study could logically evolve into a standing task force to provide timely guidance to auditors in a fashion similar to the EITF. **/

Accounting Issues

I believe that recent events clearly indicate a need to address the accounting for repurchase transactions. As noted, however, repurchase transactions are but one type of financial instrument involving issues which are not narrow in scope. These issues involve sale vs. financing treatment and perhaps mark-to-market accounting for some financial instruments. Both of these issues are of major proportion and complexity. I believe the accounting issues involved in the broad area of financial transactions and instruments should be addressed in a major project at the FASB. ***/ The downside to this approach is the time needed by the FASB to develop and complete such a project. Given the FASB's current agenda, completion of this project could be several years away. In the interim, we should continue to encourage the FASB's study of repurchase transactions to determine the feasibility of narrow fixes to deal with some of the more extreme forms of repurchase transactions.

Disclosure

As an interim measure, I believe appropriate disclosure both on the face of the balance sheet and in the footnotes is necessary for the protection of investors. Such disclosure should discuss the risks inherent in repurchase transactions in terms of overall magnitude, exposure to loss and concentration.

*/ We are not yet at a point where we can determine whether there were any audit failures with respect to Home State Savings, American Savings and Loan Association of Florida or BBS.

**/ The Accounting Standards Executive Committee of the AICPA has recently formed a task force to address the accounting issues involved in financial instruments. It is likely that if formed, the auditing task force would work closely with the existing accounting task force.

***/ The staff has previously discussed with the FASB the growing need for a comprehensive (as opposed to a piecemeal) study of the accounting issues involved in the growing array of complex financial instruments, some of which appear to be structured with the objective of taking advantage of the current historical-based accounting rules to avoid liability or loss recognition.

~~The staff will very shortly ask the Commission to approve the issuance of proposed amendments to Regulation S-X requiring such disclosures. */~~

* * * * *

Attached hereto is a more detailed discussion of the auditing and accounting issues involved in repurchase transactions.

*/ Two other organizations currently have active disclosure projects on their agendas. Both the GASB and AICPA Savings and Loan Committee expect to produce disclosure documents to their respective constituents by year-end 1985.

cc: Jeff Davis
Dan Goelzer
John Huber
Greg Jarrell
Gary Lynch
Rick Ketchum
Kathy McGrath

MEMORANDUM

May 23, 1985

TO: Clarence Sampson
FROM: Michael P. McLaughlin *M P McLaughlin*
SUBJECT: Auditing and Accounting Issues Involved in Repurchase Transactions

In preparation for your response to the Chairman's request for conclusions and recommendations concerning auditing and accounting standards relative to repurchase transactions, I have prepared the attached background material on the auditing and accounting issues involved in such transactions. This material also includes some discussion of the initiatives by several organizations that are currently addressing these same issues.

Attached to this memo is a copy of the most recent draft of the proposed report being prepared by the AICPA Special Task Force on Audits of Repurchase Securities Transactions.

cc: Ed Coulson

Repurchase Transactions

Summary of Auditing and Accounting Issues

Introduction

Repurchase agreements can involve some very complex transactions depending on the particular facts and circumstances. For purposes of discussion, this memorandum will address the transaction in its simplest form. At the outset, however, it is important to note that repurchase transactions are but one type of a very broad spectrum of financial instruments available in the market today. Many of the accounting and auditing issues discussed herein also are germane to financial instruments generally.

Company A (typically a financial institution) desires to borrow money using an "owned" security as collateral. The economics of the transaction from the borrower's perspective is usually driven by short-term liquidity needs or more likely in the case of a savings and loan, a desire to raise funds without recognizing losses on existing below market rate, long-term investments. Under historical cost accounting, treating the sale and repurchase agreement as a financing rather than as a sale allows the "borrower" to continue to carry its investment at cost with no financial statement recognition of the decline in market value.

In order to effect this borrowing, Company A utilizes a broker/dealer to locate an investor (lender) or a series of investors/lenders. Company A sells and delivers the security to the dealer and agrees to repurchase the same or substantially similar security at a specified price sometime in the future. Company A then has use of the proceeds to invest during the term of the agreement. The price to be paid on repurchase reflects the fact that Company A retains the market risk and pays interest on the borrowed funds. The lender in turn purchases the security from the dealer and holds it as collateral or has the collateral held by the dealer or its independent third-party safekeeper and agrees to sell the same or substantially similar security back to the dealer at a specified price sometime in the future.

Accounting for and auditing repurchase agreements involves issues at each stage of the transaction: borrower, dealer and lender. In addition, specialized industry accounting practices may differ between the respective parties. This memorandum will address the accounting and auditing issues involved.

Background:

Generally, selling "owned" securities or other assets with an unconditional agreement to repurchase the same securities or assets is considered in economic substance a collateralized borrowing. Such transactions are commonly referred to as "repurchase transactions," however, the savings and loan industry refers to them as "reverse repurchase transactions." The "AICPA Audit and Accounting Guide, Savings and Loan Associations" discusses repurchase transactions and describes them as:

"agreements whose terms provide that the seller will repurchase the securities within a very short period of time, usually a few days." (Emphasis added)

In addition, the "AICPA Industry Audit Guide, Audits of Banks" describes repurchase transactions as:

"a loan to the selling bank collateralized by the securities that are purchased ... usually the following day." (Emphasis added)

Further, the "AICPA Audit and Accounting Guide Audits of Brokers and Dealers in Securities" describes repurchase transactions as follows:

"A repurchase transaction, commonly known as a repo transaction, is a sale of a security coupled with an agreement by the seller to repurchase the same or substantially identical security at a stated price, which is generally the original sale price. Repurchase transactions may be made with an agreement for the dealer to buy back the same or substantially identical security at an open date to be decided by the buyer and seller. A repo is not accounted for as a sale, even though the confirmation will read that the transaction is a sale subject to an agreement to repurchase the same or substantially identical securities. Securities owned that are sold by the broker or dealer subject to a repurchase agreement are treated as collateral for financing transactions and not as sales of trading or investment positions. Therefore, they should be reported with trading and investment accounts, at market value, with the amount of the repurchase agreement reflected as a liability. Although the buyer receives many of the incidences of ownership of the securities, he is not entitled to the interest paid by the issuer of the security; instead, he receives interest on the money advanced for the purchase of those securities at a rate negotiated with the seller.

A reverse repurchase agreement, known as a reverse repo, is the purchase of a security at a specified price with an agreement to resell the same or substantially identical security at a definite price at a specific future date. For financial reporting purposes, the transaction involving the same or substantially identical securities is treated as a receivable collateralized by the security purchased, not as part of the buyer's trading or investment account.

A matched repurchase agreement occurs when a dealer buys a reverse repurchase agreement and simultaneously or shortly thereafter matches it with a repurchase agreement. The dealer makes a profit on the difference between the interest charged on the repurchase agreement. Matched repos may be executed for equal or differing amounts, with the dealer receiving more funds from the buyer than the amount being loaned to the seller. For financial reporting purposes, matched

repurchase transactions should be recorded as both assets and liabilities on the statement of financial conditions. Brokers or dealers may wish to disclose in the notes to financial statements the amounts of such matched repurchase agreements included in the statement of financial condition.

Government bond dealers who have large inventories to be financed find it advantageous to execute repos with institutional investors because a repurchase transaction usually has a lower interest rate than the government dealer loan interest rate. By using repurchase agreements, investors are able, with negligible market risk, to earn interest on their balances. The principal risk to the purchaser is the credit worthiness of the debtor."

There are a variety of ways the collateral may be handled in repurchase agreements. Generally, the securities involved in these agreements are given up by the borrower. In a reverse repurchase agreement where the identical certificate must be repurchased by the borrower (nicknamed a vanilla reverse repurchase agreement), the lender either holds the security as collateral or has it held by an independent party in safekeeping. In a reverse repurchase agreement where a substantially similar, but not identical, security must be repurchased (dollar agreement) the security is not typically placed in safekeeping and the broker may sell the security into the market or hold the security at its option.

In reverse repurchase agreements, the broker will provide a lower interest rate on a dollar transaction because the broker can use the security for resale. Similarly, brokers pay a higher return on repurchase agreements where collateral is not turned over to the lender or placed in safekeeping because it is simpler and saves the transfer fees, etc.

In the event of failure by the broker/dealer, these transactions expose the borrower and lender to loss in a number of ways depending on the treatment of collateral. The borrower, if the securities are not in its control and provided the right of offset exists, is exposed to the extent of the difference between the carrying value of the security on its books (i.e., usually historical cost) and the amount borrowed. The lender, if the securities are not in its control, is exposed in total (i.e., the amount of cash or other assets transferred to the broker).

Recent Failures

There are a number of accounting and auditing issues involving repurchase agreements that have been raised as a result of the FCA and Home State matters, as well as the recent government security dealers failures. However, the failures and the resultant losses by several financial institutions and municipalities appear to have been caused, at least in part, by fraud on the part of ESM's and BBS's management. Indeed, many people we have talked to believe that the primary problems are caused by faulty business practices (rather than faulty accounting) including the failure of registrants and accountants to fully understand the nature and extent of the risks involved.

The SEC is aware that the same collateral was used for several different repurchase agreements making unsecured lendings out of what appeared to the lender to be collateralized loans. Further, in the ESM case the loss of control over collateral surrendered by the financial institutions caused additional losses to the extent excess collateral was delivered. In the case of BBS, financial institutions delivered collateral to the dealer and rather than investing the proceeds of the borrowing elsewhere, they invested the proceeds in reverse repurchase agreements with BBS or an affiliated entity. In effect, in BBS these institutions were both the borrower and lender. These transactions exposed the financial institutions to risk of loss on 100% of the carrying value of their securities delivered as collateral. In addition, the audited financial statements of ESM did not reflect its true financial condition. In the case of ESM, transactions in nonexistent securities were recorded with an unconsolidated affiliated entity concealing material losses and defrauding those customers who relied on the audited statements in assessing the risks involved in dealing with ESM.

The issues are further clouded in the ESM case by the relationships between the principals in ESM, Home State and American Savings and Loan. However, these issues are not necessarily related solely to repurchase agreements but rather are related to fraud, its detection by the auditor, and accounting and disclosure issues concerning related party transactions.

While accounting rules cannot prevent fraudulent acts, such as those by ESM and BBS, our review of repurchase transactions does raise questions as to the adequacy of current disclosure and accounting guidance for repurchase agreements. For example, some have suggested that disclosure of the status of collateral is needed for both repurchase and reverse repurchase transactions. It has also been suggested that purchases of securities subject to resale should be separately classified as uncollateralized loans rather than investments if the lender does not have possession of the collateral. Finally, some have argued that the treatment of some or all reverse repurchase agreements should be a sale by the borrower rather than a financing arrangement and have suggested that at a minimum the underlying securities should be marked to the market or to the amount of the proceeds of the repurchase agreement.

Auditing Issues:

In response to the recent failures noted above, a special task force of the Auditing Standards Board of the AICPA was appointed to address the auditing issues involved in these transactions. The task force was comprised of AICPA members representing specialized industry groups (banking, savings and loan, broker/ dealers), governmental entities (state and local) and a regulator ("FHLBB").

The task force produced a comprehensive report for discussion on May 13, 1985, a copy of which is attached. The following is a summary of the task force's conclusion:

- 1) Existing Statements on Auditing Standards ("SAS") provide adequate and appropriate guidance for auditing repurchase transactions;
- 2) Additional educational material, discussing auditing considerations, should be added as supplemental information to the currently existing specialized industry guides;
- 3) Repurchase transactions are just one form of a growing array of extremely complex financial instruments and it is likely that the complexity of new financial instruments will surely evolve in the future. Therefore, a comprehensive study of all existing financial instruments is needed to provide guidance to auditors of parties to those instruments;
- 4) An interpretation of SAS No. 45 should be issued that reminds practitioners that because of the high risks inherent in related party transactions, auditors should examine sufficient competent evidence to be able to understand the business purpose and economic effects of sometimes admittedly complex transactions; and
- 5) It is appropriate on occasion for the auditor of the buyer - lender to obtain a report on controls instituted by a custodian over securities it holds in safekeeping for the buyer - lender.

Accounting & Disclosure Issues

The central accounting issue from the borrower's perspective is whether they have in fact entered into a collateralized financing transaction or a sale with a commitment to repurchase. Generally accepted accounting principles ("GAAP") clearly have established financing treatment as practice.

Financing treatment seems both logical and appropriate when the exact same security is delivered and repurchased within a very short period of time. However, the SEC staff has recently seen repurchase transactions where the initial term of the agreement was for as long as a year (this agreement could also be extended at maturity), the same securities were not repurchased (dollar repurchase agreements) and the initial "purchase" of securities was financed by a repurchase agreement. In addition, although many legal issues remain to be answered, it appears in these recent failures that the borrower loses control over and access to the securities collateralizing the borrowing. Further, when the agreements involve dollar repurchase transactions, the institution doesn't have the right to receive principal or interest payments because the security (i.e. mortgage pool) is no longer specifically identified and registered in the institution's name.

Accounting for reverse repurchase agreements as sales and repurchases rather than financings would have a significant impact on the S&L industry because unlike banks, the S&Ls have a far greater percentage of their assets in

long-term fixed rate, below market securities, principally GNMA. */ Under historical cost accounting, the term repurchase market allows S&Ls to effectively liquidate their portfolios of below market rate investments and mortgage backed securities (classified as loans) for extended periods without recognizing the market loss. AICPA Statement of Position 85-2 (which was issued in January 1, 1985) would require the recognition of the market loss or gain in FCA-type transactions and would require that dollar repurchase agreements on GNMA and FHLMC securities must be accounted for as sales if they are outstanding (either by initial term or renewals) for more than 1 year. However, some feel that this guidance is not restrictive enough and can be circumvented.

Another contentious issue involves dollar agreements on mortgage backed securities. SOP 85-2 codifies current practice by indicating that mortgage backed securities can be "substantially the same" even though not identical as long as they carry the same coupon rate and are backed by similar pools of mortgages. That conclusion has been questioned by those that believe the pools of mortgages backing those securities are unique and therefore cannot be viewed as "substantially the same."

There is currently no requirement in GAAP that the physical location of collateral, or the party with physical or legal control over it, be identified either on the face of the balance sheet or in the footnotes. This is true for both repurchase and reverse repurchase agreements. Segregation of the securities subject to reverse repurchase agreements (and information about the market value of such securities) on face of the balance sheet may be useful information to investors. Further, if repurchase and reverse repurchase agreements are truly lending and borrowing transactions, they should be reflected as such in the financial statements.

Disclosure of the status of collateral related to repurchase and reverse repurchase agreements may be helpful but has some implementation problems. There are also unresolved legal issues regarding the status of collateral and the rights of the various parties that could make such disclosures complex.

Recent Developments

On November 30, 1984, the Federal Home Loan Bank Board ("FHLBB") issued a proposed statement of policy concerning the accounting for various types of repurchase transactions. The Commission's staff determined that the FHLBB's issuance of such a policy might prove to be an acceptable interim measure in

*/ However, it should be recognized that requiring sales treatment in all cases may create other accounting problems in that to the extent companies, including S&Ls have mortgage backed securities and other assets that carry an interest rate higher than current market rates they could sell them pursuant to repurchase transactions and record a gain even though they have a commitment to repurchase the same or substantially similar assets, possibly within a few days. This points out that there are not any easy accounting answers to these kinds of problems.

alleviating some of the problems in this area, if certain changes were made to the proposed policy. The Commission authorized the staff to send a letter of comment to the FHLBB and on December 21, 1984 such a letter was sent. The FHLBB has not issued its final policy as yet, however, from discussions at the staff level and a review of a final draft policy, it is likely that the FHLBB will not implement certain of the SEC staff's recommended changes. Although certain changes were made to the proposed policy, the FHLBB determined not to require increased disclosure of these transactions in their filings as was strongly suggested by the SEC staff. This decision contributed to the staff's determination to propose disclosure amendments to Regulation S-X. Such recommendation will be sent to the Commission in the near future.

Following the recent failures, both the accounting profession and the private sector standard setters reacted to address these difficult issues. On several occasions in early May the staff met with representatives of the AICPA, FASB, ASB and GASB to emphasize the staff's concerns about accounting, auditing and disclosure issues.

The following initiatives are underway:

- ° The AICPA's Auditing Standards Board formed a special task force to look into the auditing issues. This task force produced a working outline by April 23, 1985 and circulated an exposure draft of their conclusions on May 14, 1985. They intend to produce a final document before June 30, 1985
- ° On May 14th, the Chairman of the AICPA Savings and Loan Committee and Chairman of the AICPA Accounting Standards Executive Committee met with the SEC staff to discuss the issuance of a Statement of Position relating to disclosure of repurchase transactions prevalent in the thrift industry. The AICPA is attempting to produce this Statement of Policy for public comment by June 30, 1985. Their intention is to have a final Statement of Position in place before year end 1985. This document would effectively supplement their Statement of Position 85-2 on accounting for certain repurchase transactions.
- ° The GASB placed the subject of accounting and disclosure for repurchase agreements on its agenda and established a special task force to address these issues from the municipalities' viewpoint. The GASB discussed the issue at its May 16th public board meeting and expects to issue an exposure draft of an accounting standard dealing principally with disclosure in the near future. They expect to have this standard in place by year end 1985.
- ° Finally, the FASB held an open meeting of the Board on May 22, 1985 to discuss the accounting issues involved with repurchase agreements. A representative of the Chief Accountant's staff participated in this meeting. The SEC staff's concern that accounting issues need to be addressed was expressed to the

Board. At the close of the meeting, the Board Chairman noted the projects being actively pursued by the AICPA and GASB and indicated that they would closely monitor these projects. Only one Board member (Art Wyatt) expressed a desire to actively pursue a Board project on financial instruments including mark-to-market accounting.

Conclusion

The issues involved in these transactions affect numerous industries and could have significant impact on the future accounting for many financial instruments. I concur with the Auditing Standards Board special task force's view that existing auditing standards are adequate for these transactions, and believe that a standing task force to study the financial instruments area and provide timely audit guidance is a worthwhile recommendation.

I also believe that the events of the past year, FCA, Home State, ESM, etc., have focused the need for the private-sector standard setters to address the accounting and disclosure issues involved in repurchase transactions. Realistically, however, the FASB is not likely to put this narrow issue on its agenda. I suggest that we consider recommending a formal Commission communication to the FASB to place the subject of financial instruments on their agenda. In addition, we can encourage the FASB to continue to study repurchase transactions and attempt to deal with the more egregious issues separately, perhaps at the Emerging Issues Task Force.