REPORT OF THE SPECIAL TASK FORCE ON AUDITS OF REPURCHASE SECURITIES TRANSACTIONS

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REPORT OF THE SPECIAL TASK FORCE ON AUDITS OF REPURCHASE SECURITIES TRANSACTIONS

INTRODUCTION

The failures of several small unregulated government securities dealers in recent years have resulted in substantial losses to investors, a depositors' run on a number of savings and loan institutions, and repercussions throughout many segments of the economy. Many of those failures involved financial instruments called repurchase and reverse repurchase (RP-RRP) agreements. RP-RRP agreements involve the purchase of securities with a promise that, at a specified time in the future and at a specified price, the transaction will be reversed -- that is, the buyer will sell the securities back to the seller. Because of the reverse feature, the agreements are often not considered to be purchases and sales but are viewed as short-term loans of cash collateralized by securities.

The losses caused by the collapse of several government securities dealers have been attributed principally to the fraudulent concealment of the dealers' financial condition and the misappropriation of investors' collateral. The media and others have raised many questions about the operation of the government securities markets and about audits of government securities dealers. Some of those questions are:

> Should the segments of the government securities market that are presently unregulated and unmonitored remain so?

Would regulating or monitoring of the failed government securities dealers have prevented their failures?

Would further monitoring of entities participating in RP-RRP agreements have limited the losses incurred?

What is the legal status of RP-RRP agreements?

Could the financial statements of the failed entities have alerted investors to the dangers of doing business with those entities?

Should the auditors of entities that engage in RP-RRP agreements alert the users of those entities' financial statements to the risks connected with particular RP-RRP transactions?

Are current auditing standards adequate for providing guidance to auditors of entities entering into RP-RRP agreements?

Only the latter three questions are within the purview of the accounting profession. Consideration of those questions must recognize the legal and economic environment in which RP-RRP agreements take place, such as,

- The importance of the government securities market to the effective and economic financing of the national debt and to the Federal Reserve Board's (FRB) control of the money supply.

- The need to consider the attendant costs and the economic incidence and effects of those costs.

- The great variety of terms, interest rates, collateral security arrangements, and even types of securities that are incorporated into RP-RRP agreements.

- The difference between the legal form of the agreement - a sale and repurchase by one entity and a purchase and resale by another - and the underlying intent of the parties to it, which may be to finance a purchase or make a collateralized loan.

- Uncertainties surrounding the legal status of RP-RRP agreements, which can lead to a misunderstanding of the various risks involved.

- The sources of business risk, market risk, credit risk, risk of collateral loss, and control risk that exist in RP-RRP agreements.

Recognizing the importance of the questions related to RP-RRP agreements, the American Institute of Certified Public Accountants appointed a special task force to study the adequacy of the existing guidance for auditing RP-RRP transactions. This report is the result of the special task force's efforts.

The task force focused primarily on considering ways in which auditors of clients engaging in RP-RRP agreements with broker-dealers in securities (or with banks acting as

broker-dealers) could assess the various risks that those agreements entail. Many of those risks are also applicable to RP-RRP transactions entered into by broker-dealers and banks acting as broker-dealers. Questions raised about the desirability of government regulation of government securities dealers are currently being addressed by the Securities and Exchange Commission (SEC), Congress, and the FRB and are beyond the purview of this task force.

Similarly, accounting issues relating to certain types of RP-RRP agreements have been addressed by the AICPA's Savings and Loan Association Committee in the recently issued Statement of Position (SOP) 85-2, Accounting for Dollar Repurchase-Dollar Reverse Repurchase Agreements by Sellers-Borrowers, and the Governmental Accounting Standards Board (GASB) is currently considering guidance to state and local governmental units in its proposed statement on Accounting and Financial Reporting for Deposits with Financial Institutions and Investments, Including Repurchase and Reverse Repurchase Agreements. The AICPA Accounting Standards Executive Committee appointed a Task Force on Financial Instruments to identify the accounting and financial reporting implications of emerging financial instruments and to review AICPA projects dealing with accounting for those instruments. Accounting and reporting issues are discussed in this report only as background to facilitate an understanding of the evolution and use of RP-RRP agreements; resolution of those issues is more appropriately within the purview of accounting standard-setting bodies.

BACKGROUND AND USE OF REPURCHASE AGREEMENTS

The evolution of RP-RRP agreements is linked directly to the issuance by the United States Treasury of large volumes of government securities. The Federal Reserve Bank, which buys and sells government securities in conducting its open market operations to implement its monetary policy, deals solely with 36 primary dealers. Those dealers consist of 13 major banks, 12 diversified brokerage firms, and 11 bond dealers. The primary dealers may hold the securities as investments, resell them to institutional or individual investors, or resell them to other dealers, known as secondary dealers, of which there may be 200 or more. The large publicized losses in recent years resulted from failures among secondary dealers.

Although RP-RRP agreements are written in the form of sales of securities with promises to repurchase them, the transactions are generally intended to serve as loans that finance investments. Primary and secondary dealers often use RP-RRP agreements to finance their significant holdings of government securities. Dealers enter into those financing agreements with savings and loan institutions, governmental units, credit unions, pension funds, mutual funds, other institutional investors, and other dealers. The entities that initially remit cash for an interest in securities are called buyer-lenders in this report; the entities that initially receive cash for an interest in securities are called seller-borrowers. A single entity may sometimes be a buyer-lender and at other times be a seller-borrower. Most RP-RRP agreements

are contracts for the sale and purchase of U.S. Treasury bonds, bills, and notes. Agreements may also be made, however, for the sale and purchase of other financial instruments, such as mortgage-backed securities, bankers' acceptances, negotiable certificates of deposit, and commercial paper.

Use as Investments or Loans

Buyer-lenders generally view RP-RRP agreements as short-term,* low risk investments or loans. A buyer-lender transfers cash to a seller-borrower and receives securities (or has securities held on its behalf) as "collateral," and the seller-borrower agrees to take back the securities and repay the cash plus interest at a future date.

For many buyer-lenders, RP-RRP agreements are the shortest term investments or loans available, sometimes as short as one day. The yield is relatively high for such short-term investments and can sometimes be improved further if the buyer-lender agrees not to require delivery of the securities from the seller-borrower. Many entities engaging in RP-RRP transactions as buyer-lenders believe that, because the transactions are generally collateralized by U.S. government securities, they are exposed to little risk of loss in the event of default or bankruptcy of a seller-borrower. Risks relating to market changes and the credit worthiness of the seller-borrower may exist, however, and are discussed below.

*Short-term is generally considered to be from one to thirty days.

For some buyer-lenders, such as state and local governmental units which are prohibited from availing themselves of certain types of investments, RP-RRP agreements having Federal government obligations as the underlying security provide an acceptable form of investment. State and local governmental units prefer to interpret the agreements as purchases and subsequent sales of securities because state law may not specifically permit investments in repurchase agreements and may prohibit loans to private parties. State law usually allows investments in securities that underlie those agreements, which permits the transactions to be interpreted as legal investments.

Use as a Means of Borrowing Funds for Additional Investment

Entities sometimes use RP-RRP agreements to obtain funds for additional investment. In such instances they act as seller-borrowers, transferring securities to buyer-lenders for cash and promising to repay the cash plus interest in the future in exchange for the same securities. The cash obtained in exchange for the securities is reinvested for the term of the RP-RRP agreement, with the expectation that the interest paid on the borrowing will be less than the earnings on the investment.

Use to Finance the Purchase of Government Securities

As previously noted, primary and secondary dealers use RP-RRP agreements to finance their government securities holdings. Other entities may also finance purchases of government securities by entering into RP-RRP agreements. The

seller-borrower arranges to transfer the securities, which it may not yet own, to the buyer-lender for the cash needed to buy the securities. Alternatively, the seller-borrower could order the securities from or through the buyer-lender, but not take delivery, leaving the securities with the buyer-lender as collateral for the loan of the purchase price. The seller-borrower promises to repay the debt in the future, possibly by allowing the repurchase to lapse or by selling the securities to a third party.

Similarities with Other Types of Transactions

RP-RRP agreements are hybrids, having elements of both buy-sell transactions and collateralized loans. Buyer-lenders in RP-RRP transactions have risks and rewards of ownership that are similar in most respects to those attaching to investments in general. Among those are the right to use or trade the securities during the term of the agreement and to keep any resulting profits; buyer-lenders also incur the risk of any resulting losses.

Many characteristics of RP-RRP agreements make them analogous to collateralized loans. For example, buyer-lenders earn interest on the amount of cash that is exchanged, not on the face or market value of the securities. Also, the interest earned is specified by the terms of the agreements; it is not based on the interest rate specified in the underlying securities. If a seller-borrower defaults on its commitment to repurchase the securities (repay the loan) and the buyer-lender

liquidates the underlying securities, any excess of the proceeds over the repurchase price is ordinarily returned to the seller-borrower. Furthermore, if the market value of the underlying securities declines, the buyer-lender may have the contractual right to require the seller-borrower to increase the amount of the securities or, alternatively, reduce the amount of the loan.

The terms of a particular RP-RRP transaction determine whether it should be viewed as a sale or purchase of securities with a commitment to later reverse the transaction, or as a collateralized loan with commitments to repay the loan and return the collateral. Accounting standard-setting bodies have addressed that question in the course of prescribing the appropriate accounting for RP-RRP transactions. A later section of this report notes the accounting measurement and disclosure requirements for those transactions.

TERMINOLOGY

Both the stockbrokerage and government securities industries are replete with specific industry terms and technical jargon. Some of the more frequently used terms are defined and explained below and are used throughout this report. Those seeking greater familiarity with the stockbrokerage industry may wish to consult the AICPA audit and accounting guide for brokers and dealers or industry publications.

Repurchase-Reverse Repurchase Agreements

The GASB explains a repurchase agreement in its proposed statement, as follows:

> State and local governmental entities sometimes place excess cash in repurchase agreements with broker-dealers and financial institutions. In a repurchase agreement transaction, the governmental entity (buyer-lender) transfers cash to a broker-dealer or financial institution; the broker-dealer or financial institution (the seller-borrower) transfers securities to the governmental entity and promises to later repay the cash plus interest in exchange for the return of the same securities. [This transaction is called a repurchase agreement by governmental entities, savings and loan institutions, and others. When broker-dealers and banks acting as broker-dealers are buyer-lenders, they refer to agreements to transfer cash, receive securities, and subsequently to return the securities for cash as reverse repurchase agreements.]

The GASB defines a reverse repurchase agreement as follows:

> State and local governmental entities sometimes enter into reverse repurchase agreements when they want to temporarily convert securities in their portfolios to cash. In this transaction, the entity acts as the seller-borrower, transfers securities to someone else for cash, and promises to later repay cash plus interest in exchange for the return of the same securities. The cash obtained in these transactions is often used for operating or capital purposes or reinvested in other securities. [This transaction is called a reverse repurchase agreement by governmental entities, savings and loan institutions, and others. When broker-dealers and banks acting as broker-dealers are seller-borrowers, they refer to agreements to transfer securities for cash, and subsequently to repay cash for the securities as repurchase agreements.]

Matched Book Transactions

Many dealers entering into RP-RRP agreements frequently use the term "matched book" transactions. In a matched book transaction or matched book operation, a dealer effects a repurchase and reverse repurchase transaction with the same underlying securities for the same period of time, usually at slightly different rates. The market risk of loss from price changes on one side of the transaction is offset by an equal amount of gain from price changes on the other side of the transaction.

Time Periods Involved

RP-RRP agreements are negotiated for different time periods, as follows:

- Overnight RP-RRP agreements. Mature in one day.
- Term RP-RRP agreements. Mature in more than one day.
- Open RP-RRP agreements. Have no specified maturity date; both parties typically have the right to close at any time. An effective open agreement may be achieved by continuously rolling over an overnight agreement into another overnight agreement.

- RP-RRP agreements to maturity. Term extends to the maturity date of the underlying security.

Variations on the Basic Agreement

RP-RRP transactions sometimes take the form of dollar RP-RRP agreements, which are transactions involving the return of securities that are similar to, but not the same as, the securities originally transferred. AICPA SOP 85-2 contrasts dollar RP-RRP agreements with the basic RP-RRP agreement as follows:

> Repurchase-reverse repurchase agreements involve identical securities, and the substance of the transactions is to borrow and lend funds. Dollar repurchase-dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. However, in agreements involving certificates collateralized by dissimilar pools [of mortgages], these transactions would be accounted for as sales and purchases.

Dollar RP-RRP agreements generally take the form of fixed coupon or yield maintenance agreements. In fixed coupon agreements, the parties agree that when the dollar RP-RRP agreement is unwound, certificates having the same stated interest rate as that on the certificates sold will be delivered. In yield maintenance agreements, the parties specify in the agreement the yield of the certificates to be delivered when the dollar RP-RRP agreement is unwound.

SOP 85-2 concludes that yield maintenance agreements constitute separate sale and purchase transactions. Therefore, unlike fixed coupon agreements meeting specified criteria, yield maintenance agreements would be accounted for as completed sales and purchases.

Pricing and Yield on RP-RRP Agreements

The "repurchase" price established in an agreement may be the same as the initial "sale" price. In that case, the rate of interest to be paid by the seller-borrower upon "repurchase" is generally specified. Alternatively, the agreed-upon "repurchase" price may be slightly higher than the initial "sale" price, reflecting the cost to the seller-borrower of using the buyer-lender's cash during the term of the agreement. Competition among buyer-lenders and seller-borrowers, their relative bargaining strengths, and their astuteness all affect the yield on a particular RP-RRP transaction.

"Haircuts"

The excess of the market value of the securities transferred by the seller-borrower over the amount of cash transferred by the buyer-lender in an RP-RRP agreement is called a "haircut." A haircut is a margin of safety sought by the buyer-lender to guard against a decline in the value of the "collateral" as a result of rising interest rates during the term of the agreement. Whether an agreement provides for a

haircut, as well as the amount of the haircut agreed upon, depends on competition among buyer-lenders and seller-borrowers and their relative bargaining strengths.

Haircuts generally range from a fraction of one percent to four or five percent. The principal considerations in setting the haircut for a particular repurchase transaction are:

- The length (or term) of the agreement.
- The type of customer and its credit worthiness.
- The type of securities underlying the agreement, the length of time to their maturity, and the credit worthiness of the issuer of those securities.
- The volatility of the market value of the underlying securities.
- The differential between the interest rate specified in the agreement and the interest rate on the securities.

The Federal Reserve Book Entry System

All United States Treasury issues, except registered securities, and many United States government agencies' issues exist only in book entry form, in computerized files maintained by the 12 Federal Reserve Banks ("the Fed"), rather than in definitive (engraved paper) form. The book entry system is a securities safekeeping arrangement between the Fed and its securities safekeeping account customers. Any depository

institution, as defined in the Monetary Control Act of 1980, may open securities safekeeping accounts with the Fed. Such depository institutions include commercial banks, savings and loan associations, credit unions, and certain other depositories. In addition, the Fed may also maintain securities safekeeping accounts for certain other entities, such as bankruptcy courts. A single depository institution may maintain several accounts on the system, for example, an account for securities owned, an account for securities held in trust for others, and an account for clearing dealers' transactions. Under the system, book entry securities are transferred electronically between securities safekeeping accounts based on input from the depository institution transferring securities from a safekeeping account.

The book entry records are adjusted only for transfers between securities safekeeping accounts maintained at the Fed. Such transfers may involve accounts maintained by different customers or different accounts maintained by a single customer. Other transfers of securities by a depository institution between accounts of two of its customers would be reflected only on its records (notation entry), but not on the Fed's records -- unless the transaction involved a transfer between different safekeeping accounts maintained at the Fed by the particular depository institution, such as between a trust safekeeping account and a clearing safekeeping account. Similarly, a transfer of book entry securities between two customers (e.g., a dealer and the dealer's retail customer) of

a depository that does not maintain a safekeeping account with the Fed but is itself a customer of a depository that maintains such a safekeeping account will not be reflected in either the latter depository's records or in the Fed's records, but would result in a notation entry on the former depository's records. Also, a dealer's book entry transaction not involving a change in book entry securities accounts, such as a transfer between two customers or a sale with an agreement to repurchase at a later date in which the dealer retains the securities, results in an entry in the dealer's records but no adjustment to an intermediary depository's records or those of the Fed.

REGULATORY ENVIRONMENT

Dealers that engage exclusively in U.S. government securities, including some of the 36 primary dealers, are currently not directly regulated by any governmental or self-regulatory agency in their capacity as dealers in government securities. Government securities are exempt from registration under the Securities Act of 1933 and the Securities Exchange Act of 1934, and dealers that engage exclusively in government securities transactions are exempt from regulatory oversight by the Securities and Exchange Commission. Transactions in government securities, however, are subject to the antifraud provisions of the federal securities laws (e.g., Sections 17(a) of the 1933 Act and 10(b) of the 1934 Act).

Primary Dealers

The Federal Reserve Board monitors the activities and financial stability of the 36 primary dealers, which report their trading positions and market activity daily to the Fed. The primary dealers also provide monthly financial statements and annual reports and are subject to other surveillance and oversight. Primary dealers that are banks are also subject to the regulatory oversight of other federal bank regulators, such as the Comptroller of the Currency and the Federal Deposit Insurance Corporation, and any holding companies of those banks are also required to report financial and other information to the SEC and the National Association of Securities Dealers if they effect transactions in corporate or municipal securities.

Secondary Dealers

In contrast to the primary dealers, dealers engaging exclusively in government securities in the secondary market are not subject to the surveillance or reporting requirements of any regulatory authority. However, the Federal Reserve Board encourages voluntary reporting by the unregulated dealers similar to that required of the primary dealers. The Federal Reserve Board is currently considering issuing capital adequacy and related reporting guidelines for unregulated dealers that they will be encouraged to comply with on a voluntary basis.

Although those secondary dealers are not required to report to the SEC, the SEC does have investigative authority over dealers in government securities that are suspected of having violated the antifraud provisions of the federal securities laws in connection with government securities transactions, and it can bring injunctive actions in Federal court, but not in-house, administrative actions, against such dealers for violations of the antifraud statutes. In light of recent failures among secondary government securities dealers and the consequential losses of millions of investors' dollars, Congress and others are considering the necessity of some form of regulation or monitoring of unregulated government securities dealers.

Other Participants

Many other participants in RP-RRP agreements are also regulated by various governmental and self-regulatory agencies: Most banks are subject to one or more of the following federal bank regulators -- the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; certain savings and loan associations report to the Federal Home Loan Bank Board; some credit unions report to the National Credit Union Association; and nongovernmental pension funds are regulated by the U.S. Department of Labor under ERISA. Insurance companies and state-chartered banks and savings and loan associations are regulated by various state agencies. State and local governments are subject to state laws and regulations or their own established oversight procedures.

LEGAL CONSIDERATIONS

Legally, an RP-RRP transaction does not automatically create a security interest or a pledge of collateral by a seller-borrower to a buyer-lender. Economically, an RP-RRP agreement involves a loan of money collateralized by securities (or, conversely, a borrowing of securities in exchange for money). Nevertheless, to create a valid security interest under the Uniform Commercial Code,* the safest approach is to have a separate signed agreement specifically creating the security interest and perfection of the security interest, normally by possession of the collateral.** Some RP-RRP participants provide explicitly in their agreements for security interests that would have standing as such under the Uniform Commercial Code. More commonly, however, RP-RRP transactions do not create security interests; instead, they involve only a pair of matched confirmations that are similar to an initial purchase or sale transaction coupled with a forward contract that will, in effect, reverse the first transaction at a price that provides for the payment to the buyer-lender of what is, in effect, interest.

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*The Uniform Commercial Code has been enacted, with minor variations, in all states except Louisiana.

**There are state by state variations in the Uniform Commercial Code (Section 8-321) on this point. In addition, the courts may choose, for one reason or another, to recognize a particular RP-RRP agreement as a secured loan. Currently ongoing litigation concerning Bevill, Bresler & Schulman Asset Management Corp. and E.S.M. Government Securities, Inc. may yield judicial precedents on what is required to perfect a security interest.

The treatment of the securities underlying an RP-RRP agreement that does not involve a secured loan is critical if the interests of the seller-borrower and buyer-lender are to be protected. If the seller-borrower over-collateralizes the agreement by selling the securities at too great a discount from the market price, its rights to the overage may be diminished or lost entirely in the event of the buyer-lender's bankruptcy. In that case, the seller-borrower may find that neither the securities nor funds to replace the securities are available for the buyer-lender to complete the RP-RRP transaction and, as a result, may incur an economic loss to the extent the agreement was overcollateralized. (The accounting loss would be greater than the economic loss if the market value of the securities is below their book value; the accounting loss would be less than the economic loss if the market value is above the book value.) Conversely, the buyer-lender's rights to the collateral in an RP-RRP transaction may be seriously affected if the buyer-lender fails to take possession of the securities, either itself or on its behalf by a third party serving as its agent. In current bankruptcy cases involving secondary dealers, several RP-RRP buyer-lenders that did not take possession of their securities may be unable to recover them.

Taking possession of the underlying securities may be accomplished either directly by the buyer-lender or indirectly through a third party that, acting as the buyer-lender's agent, takes possession of and holds the securities for the exclusive

use of the buyer-lender. Such a custody agreement should be evidenced in writing for the buyer-lender's protection, and the custodian should be required to specifically identify and segregate the securities held for the buyer-lender.

The 1984 amendments to the U.S. Bankruptcy Code exempt certain RP-RRP agreements of a fixed term of one year or less from the automatic stay orders typically issued by bankruptcy courts. That is, in the event of the seller-borrower's bankruptcy, the buyer-lender can liquidate the underlying securities and in effect set off the "collateral" against the "loan." For the transaction to qualify as an RP-RRP agreement as defined in the Code, the underlying securities must be transferred to the buyer-lender and must comprise "certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States."*

Government securities dealers, except for certain financial institutions such as commercial banks and savings and loan associations, are subject to the Bankruptcy Code. The Federal Home Loan Bank Board (FHLBB) in October 1984 indicated that its policy in cases where the Federal Savings and Loan Insurance Corporation was the receiver of an insured institution was to not limit the contractual rights of the

*Public Law 98-353, Subtitle F, section 391.

buyer-lender to sell securities underlying repurchase agreements except in cases of fraud or other extraordinary circumstances. Similar action has not been taken, however, by the Federal Deposit Insurance Corporation, but its practices have been consistent with those formally adopted by the FHLBB. The powers of receivers and conservators of bankrupt institutions that are not subject to the Bankruptcy Code are governed by many differing federal and state statutes and regulations. Accordingly, the rights of each party to the underlying securities in the case of insolvency may not always be treated by the courts in the manner specified in the particular RP-RRP agreement (or master agreement). Nevertheless, those agreements should contain language that defines what each party intends its rights to be.

ACCOUNTING AND REPORTING CONSIDERATIONS

This section discusses accounting principles applicable to RP-RRP agreements. The existing guidance on accounting for RP-RRP agreements generally views such agreements as financing transactions. Accordingly, the securities "purchased or sold" as part of an RP-RRP transaction are not recognized as such for accounting purposes by either the seller-borrower or the buyer-lender; instead, the transaction is generally accounted for by both parties as a collateralized loan, with the related asset and liability reflected in financial statements at the contract value of the agreement.

AICPA Audit and Accounting Guides

The AICPA Audit and Accounting Guide, Audits of Brokers and Dealers in Securities, recognizes RP-RRP transactions as financing transactions and discusses them from the viewpoints of buyer-lenders and seller-borrowers. From the viewpoint of buyer-lenders, the guide states:

> 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.

The guide captions the collateralized receivable as "Securities purchased under agreements to resell."

From the viewpoint of seller-borrowers, the guide states:

> 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.

The guide captions the liability as "Securities sold under agreements to repurchase."

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*Broker-dealers maintain investment accounts at market value.

The AICPA Audit Guide, Audits of Banks, recognizes RP-RRP agreements as financing transactions, with the borrowing reflected as a liability and the securities sold reflected as investments.

The AICPA Audit and Accounting Guide, Savings and Loan Associations, states that material RP-RRP agreements should be disclosed in the financial statements. The guide specifies that when a savings and loan association enters into an RP-RRP agreement as a seller-borrower, a liability should be established for the amount of the proceeds. The investment account should not be relieved of the securities that underlie the agreement.

AICPA SOP 85-2

The AICPA guides provide accounting guidance for basic RP-RRP agreements (sometimes referred to as "plain vanilla" agreements). SOP 85-2 provides accounting guidance for dollar RP-RRP agreements. The statement concludes that fixed coupon dollar RP-RRP agreements meeting certain criteria should be considered financing transactions and reported accordingly; yield maintenance RP-RRP agreements should be accounted for and reported as completed purchases and sales of securities.

GASB Proposed Statement

The GASB's proposed statement parallels the guidance in the AICPA guides and SOP 85-2. The statement provides the following accounting and reporting guidance when a governmental entity enters into RP-RRP transactions as a seller-borrower:

> The assets and liabilities arising from reverse repurchase and fixed coupon reverse repurchase agreements should not be netted on the balance sheet. Reverse repurchase and fixed coupon reverse repurchase agreements should be reported as a fund liability or a proprietary fund liability as "Obligations under reverse repurchase agreements," and the underlying securities should be reported as "Investments."
>
> In the operating statement, the results of repurchase and fixed coupon repurchase agreements should be shown as interest income. The interest cost of the reverse repurchase and fixed coupon reverse repurchase agreements should be reported as interest expenditure/expense. The interest cost associated with reverse repurchase or fixed coupon reverse repurchase agreements should not be netted against interest earned on any associated investments.
>
> Yield maintenance repurchase and reverse repurchase agreements should be accounted for as a purchase and sale and sale and purchase of securities, respectively. Securities purchased should be recorded at cost and a gain or loss on investments should be recognized on securities sold.

The proposed statement suggests disclosure of additional information, including the governmental entity's investment policies, the agreement activity during the year, and agreements outstanding at year-end.

FASB Statement

The accounting for RP-RRP agreements that is specified by Financial Accounting Standards Board (FASB) Statement No. 65, Accounting for Certain Mortgage Banking Activities, is similar to the accounting in the AICPA audit and accounting guides and the proposed GASB statement. The FASB statement also describes the following circumstances in which informal agreements should be treated as formal RP-RRP agreements:

> Mortgage loans or mortgage-backed securities also may be transferred temporarily without a repurchase agreement but under circumstances that indicate a repurchase agreement exists on an informal basis, for example, when the mortgage banking enterprise (a) makes all of the necessary marketing efforts, (b) retains any positive or negative interest spread on the loans or securities, (c) retains the risk of fluctuations in loan or security market values, (d) reacquires any uncollectible loans, or (e) routinely reacquires all or almost all of the loans or securities from the bank or other financial institution and sells them to permanent investors. Mortgage loans and mortgage-backed securities held for sale that are transferred under formal or informal repurchase agreements of the nature described in this paragraph shall (1) be accounted for as collateralized financing arrangements and (2) continue to be reported by the transferor as being held for sale.

RISKS INVOLVED IN REPURCHASE-REVERSE REPURCHASE AGREEMENTS

Each party that enters into an RP-RRP agreement faces several types of risk. These are business risk, market risk, credit risk, and the risk of collateral loss, each of which is discussed below. Also discussed are controls that parties to RP-RRP transactions can install to reduce those risks.

Business Risk

The business risk associated with RP-RRP agreements is that a party entering into them will misunderstand their terms and therefore misunderstand the economics of the transactions and incorrectly assess the risks it is in fact assuming, the return it hopes to earn, or the financing costs it is incurring. That misunderstanding can result from incorrectly pricing the agreements or from incorrectly treating accrued interest in pricing the underlying securities. Particularly because transactions that are RP-RRP agreements are not always labeled as such, and vice versa, parties to them may not always be aware of the actual risks and returns being contracted for and accordingly may not account for them properly.

Market Risk

All securities are subject to market risk in that their prices can change in ways that are not anticipated. The prices of government securities change in response to changes in interest rates: while price changes may be small, they can

result in material gains or losses because of the large dollar amounts involved in many government securities transactions. Price changes may affect the ability of one party to an RP-RRP agreement to continue to finance it and the ability of the other party to replace the securities when the transaction is supposed to be reversed. Changes in prices also affect the margin in a transaction (the "haircut") and may create a need for the seller-borrower to transfer additional securities or return cash. Accordingly, both parties should monitor on a daily basis the market value (including accrued interest) of securities subject to RP-RRP agreements.

Credit Risk

Credit risk is the risk that a borrower may not be able to repay a loan. An RP-RRP agreement can be viewed as a loan of cash by one party and a loan of securities by another. When the agreement is unwound, both "loans" are "repaid." There is a risk that the buyer-lender, having sold or otherwise transferred the securities to third parties, will not have sufficient resources at the maturity of the agreement to obtain the securities required for resale to the seller-borrower. There is also a risk that the seller-borrower will not have sufficient funds to repay the loan (repurchase the securities). Thus, credit risk is faced by both parties to the transaction. Particularly because government securities dealers are often organized as separate affiliates of securities broker-dealers, parties to RP-RRP transactions should be careful to identify the specific entity with which they are doing business.

The risk that the issuer of the underlying securities may default is also present, except in the case of securities issued or guaranteed by the U.S. government or its agencies. This risk relates to RP-RRP agreements involving bankers' acceptances, negotiable certificates of deposit, mortgage-backed obligations of nongovernmental enterprises, and similar instruments.

The credit risk to which a particular entity may be exposed can be affected by the extent to which the entity's RP-RRP position is concentrated in any one underlying security or with any one party. Credit risk is related to market risk in that changes in market prices generally and attendant economic losses may affect a seller-borrower's ability to repay the loan (repurchase the securities) or a buyer-lender's ability to return the securities. The extent of credit risk, therefore, can be masked if the parties to the transaction do not continually review and evaluate their securities positions on a market value basis, including accrued interest.

The extent of credit risk faced by a party that enters into RP-RRP transactions with a government securities dealer is also related to the dealer's business policies and practices regarding control and use of collateral, the extent of the "haircut" on securities serving as collateral, the extent to which the dealer maintains a matched book, and the dealer's capitalization. As noted in the section on "Legal Considerations," uncertainties surround the legal status of the

securities that the parties to RP-RRP transactions view as collateral. Consequently, some believe it is possible that a buyer-lender may be assuming lower risk by not taking delivery of collateral from a dealer that has good internal accounting controls and is well capitalized than by taking delivery from a poorly controlled, highly leveraged dealer.

Risk of Collateral Loss

When a seller-borrower transfers securities to a securities dealer under an RP-RRP agreement, there is a risk that the dealer may not be able to reverse the transaction by selling the securities back at the agreed-upon price. If the seller-borrower has the legal right to set off the securities against the borrowed funds, the potential economic loss is limited to the excess of the market value of the securities (plus accrued interest) at the date of the sale over the amount borrowed, plus or minus any change in that market value and accrued interest.* In that case, the risk of losing the collateral is essentially the same as market risk. If the seller-borrower does not have the legal right of setoff, the potential economic loss extends to the full value of the securities.

*The accounting loss may be greater or less than the economic loss if the book value of the securities is above or below their market value.

If a buyer-lender under an RP-RRP agreement with a securities dealer does not perfect a security interest in securities purchased (for example, by having a signed agreement and by taking possession), the potential economic loss also extends to the full value of the securities and the risk assumed becomes that of an unsecured lender, namely, credit risk. Collateral risk for the buyer-lender is reduced if the collateral is held by the dealer's custodian as the dealer's agent with specific identification of the assignee; the risk is reduced even further if definitive collateral is "locked up" in safekeeping and segregated and identified by customer or if book entry collateral is transferred directly or by a fiduciary's notation. Collateral risk is least if the buyer-lender or its agent (which could be the dealer's bank acting as the lender's agent) takes possession of the collateral.

Controlling Risk

The various risks faced by entities entering into RP-RRP transactions are generally reduced by instituting controls over the authorization, processing, and recording of those transactions. Such controls might include policies and procedures that (a) require transactions to be executed pursuant to written contracts setting forth the rights and obligations of the several parties,* (b) place trading limits

*Some RP-RRP transactions are executed under both master repurchase agreements that outline the basic rights and obligations of both the buyer-lender and seller-borrower and under specific repurchase agreements that confirm the terms of specific transactions. The specific agreements incorporate the terms of the master agreement. Buyer-lenders also often enter into agreements with their custodial banks that specify the basic responsibilities of the buyers and the custodians.

on personnel, (c) restrict agreements with specified dealers and to specified securities, and (d) require reviews of transactions for reasonableness and completeness, periodic evaluations (preferably daily) of the appropriateness of the amounts of collateral or borrowings, and evaluations of credit and collateral risk.

AUDITING CONSIDERATIONS

This section of the report reviews the existing auditing literature addressing RP-RRP transactions and provides additional insight for auditors in applying the guidance included in that literature.

Existing Auditing Literature

The standards of field work and Statements on Auditing Standards that interpret those standards provide broad guidance on assessing control risk* through the study and

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*Control risk is defined in Statement on Auditing Standards No. 47, Audit Risk and Materiality in Conducting an Audit, as "the risk that error that would occur in an account balance or class of transactions and that could be material, when aggregated with error in other balances or classes, will not be prevented or detected on a timely basis by the system of internal accounting control." Business risk, market risk, credit risk, and collateral risk are aspects of inherent risk, which is defined in SAS No. 47 as "the susceptibility of an account balance or class of transactions to error that could be material, when aggregated with error in other balances or classes, assuming that there were no related internal accounting controls."

evaluation of internal control and on controlling detection risk* through obtaining and evaluating sufficient, competent evidential matter. The objective of that broad guidance, which is applicable to all engagements and therefore should be considered by auditors of clients that enter into RP-RRP agreements, is to assist auditors in designing, performing, and evaluating the results of procedures that will reduce audit risk** to an appropriately low level. Statements on Auditing Standards are not intended to and do not provide detailed guidance on auditing specific industries, types of transactions, or classes of accounts.

Several AICPA audit and accounting guides address RP-RRP agreements in the context of audits of clients in specialized industries. Proposed guides, some of which are revisions of existing guides, also address those agreements. A summary of the auditing guidance in the existing and proposed guides follows.

Audits of Brokers and Dealers in Securities. The section of this report on accounting and reporting considerations explains that the broker-dealer guide treats RP-RRP

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*Detection risk is defined in SAS No. 47 as "the risk that an auditor's procedures will lead him to conclude the error in an account balance or class of transactions that could be material, when aggregated with error in other balances or classes, does not exist when in fact such error does exist."

**Audit risk is defined in SAS No. 47 as "the risk that an auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated."

agreements as financing transactions. The guide explains that when the broker-dealer is the buyer-lender, the transaction is accounted for and reported as a receivable collateralized by the securities purchased. When the broker-dealer is the seller-borrower, the securities transferred remain in its investment account and the borrowing is reflected as a liability. Therefore, auditors of broker-dealers engaging in RP-RRP transactions are essentially dealing with the examination of investments, collateralized receivables, and short- or long-term debt.

The guide discusses primarily the study and evaluation of internal controls and the examination of accounts that are peculiar to the stockbrokerage industry. Accordingly, considerable attention is given to the examination of stock record positions and investments, and a chapter is devoted to a discussion of U.S. government and money market instruments - the major securities underlying RP-RRP agreements. The study and evaluation of internal controls and the examination of collateralized receivables and short- and long-term debt transactions and balances involve many procedures that are not industry specific and therefore are not repeated in the broker-dealer guide. The guide provides illustrative financial statements that include RP-RRP agreements and their attendant disclosures. In common with all other audit and accounting guides, the guide discusses accounting transactions, accounting records, internal accounting controls, and client procedures

for safeguarding assets that are unique to the stockbrokerage industry. The guides do not, however, attempt to provide detailed audit programs and questionnaires; the design of such audit tools is left to the auditor's judgment.

Audits of Banks. Chapter 9 of the guide, Audits of Banks, entitled "Federal Funds and Repurchase/Reverse Repurchase Agreements," describes the nature of the transactions, their use by banks, and, as mentioned earlier in this report, the treatment of the agreements as financing transactions. The guide explains that the audit objectives for RP-RRP agreements are to obtain reasonable assurance that the asset and liability balances represent valid amounts due from or to others and that revenues and expenses are stated in conformity with generally accepted accounting principles. Certain internal accounting control considerations and illustrative audit procedures are provided to assist the auditor in the examination. Illustrative financial statements that reflect RP-RRP agreements are also provided.

Savings and Loan Associations. In the savings and loan associations guide, the chapter on accounting principles and auditing procedures explains that an association may invest in short-term RP-RRP agreements and also may borrow under these arrangements, using securities as collateral. The chapter provides auditing, accounting, and reporting guidance on investments in securities in general and also contains extensive discussion of loan examination procedures. The examination of borrowings under RP-RRP agreements is not

specifically addressed, because audit procedures are similar to those followed in audits of other commercial and industrial enterprises.

Audits of State and Local Governmental Units, Audits of Investment Companies, and Audits of Credit Unions. The state and local governmental units guide and the investment companies guide are currently being revised. Both revisions have been exposed for public comment and comments received are being considered. Both exposure drafts include discussions of RP-RRP agreements and of audit procedures related to the examination of securities and investments. Where applicable, auditing procedures for specific industry loans and liabilities are discussed.

The proposed guide, Audits of Credit Unions, in common with the guides mentioned above, discusses RP-RRP agreements and explains that they are treated as short-term investment and borrowing transactions. The audit objectives and procedures for testing investment and liability accounts are also explained. The proposed guide has been exposed for comment.

The above review of existing and proposed audit and accounting guides suggests that much guidance is already available on auditing RP-RRP transactions, but that it is not codified in one document and not sharply focused on all of the risk factors associated with those transactions. The task force believes that more specific and illustrative guidance on

auditing RP-RRP transactions is needed, because of the complexity of those transactions, the risks involved, and the controls over those risks. The guidance that follows reflects the task force's views as to the nature of that guidance.

Auditing Considerations When Repurchase-Reverse Repurchase Agreements Exist

The remainder of this section discusses conditions that should enter into the auditor's determination of whether audit risk has been reduced to an appropriately low level through the design, performance, and evaluation of the results of audit procedures when a client has entered into contracts that should be accounted for as RP-RRP agreements. Not all the considerations discussed below may be applicable to the audit of a particular entity. Accordingly, the guidance provided for addressing each of the considerations also may not be applicable to a particular audit situation. Rather, the procedures discussed should be viewed as ways to apply generally accepted auditing standards and the guidance contained in the various audit and accounting guides.

Auditing Accounts Reflecting Selling-Borrowing Transactions

This section discusses factors to be considered by auditors of entities, other than securities dealers, that enter into agreements to sell and later repurchase the same or substantially the same securities (reverse repurchase agreements).

<u>Responding to Business Risk</u>. Reverse repurchase agreements, like any other contract, can be structured to provide various combinations of risk and return. Conceptually, the terms and yield on a given investment should reflect the risk preferences and business objectives of each party to the agreement. A combination of risk and return that does not conform to the seller-borrower's intended preferences produces either too little return for the risk intended to be assumed or too much risk for the return actually earned: either situation is undesirable.* Seller-borrowers should be aware of the relationship of risk to return; the auditor should understand the nature of the transactions that are being used to achieve the intended business strategy.

The terms of individual reverse repurchase agreements, particularly "overnight repos," are not always stated in writing, which may make it difficult to evaluate the risks assumed by the seller-borrower, particularly when overnight repos are extended by the parties for long periods of time. Inadequate documentation also makes it difficult to determine that all reverse repurchase agreements are recognized as such (even if the broker confirms transactions as sales and subsequent purchases), but it does not relieve the auditor of the responsibility to look for unrecorded agreements. A review of transaction activity may indicate that an event accounted

*The risk addressed in this section is related to the various risks inherent in the underlying securities and the risks associated with the other party to a transaction.

for as two separate transactions--a sale and a subsequent purchase--is in reality a reverse repurchase agreement. The auditor should also be alert for invalidly recorded transactions, since accounting for what in reality are separate sale and purchase transactions as reverse repurchase agreements may reflect an attempt to avoid recognizing a gain or loss on the sale.

Responding to the Risk of Collateral Loss. In a reverse repurchase transaction, the seller-borrower must rely on the buyer-lender's integrity and its ability to be in a position to fulfill its obligation to honor the sale-back when the transaction is closed. Accordingly, the seller-borrower should have controls in place to monitor market risk and credit risk, and the auditor should be aware of the guidance provided below under those headings. Confirming the transaction with the dealer will provide evidence of the occurrence of the transaction, its terms, and treatment of the securities; confirmation will not provide evidence about the existence, location, or transferability of the securities, or about the dealer's ability and intent to complete the transaction.

If the buyer-lender is a dealer, it will usually be impracticable to confirm the location of the securities delivered to the dealer as collateral. The dealer often will not be able to determine the location of the securities because they are fungible with other securities under the dealer's control and are commingled with those securities. The seller-

borrower and its auditor need not necessarily be concerned, however, about the location of securities transferred to the dealer as collateral, since their location does not affect the risk that the dealer may not complete the transaction.

The auditor should evaluate the adequacy of financial statement classification and disclosure of RP-RRP transactions in general and of the collateral in particular. Those disclosures should enable financial statement users to assess the level of credit and collateral risk to which the entity is exposed. The Governmental Accounting Standards Board is currently considering the disclosures that should be required of governmental units that enter into RP-RRP agreements. That guidance may also be helpful in considering the appropriateness of disclosures by other entities that enter into such agreements. The AICPA Savings and Loan Associations Committee is also considering the disclosures that should be required of those institutions.

Responding to Market Risk. As noted earlier, changes in market interest rates may affect an entity's ability to continue to finance an RP-RRP transaction; the effect may be intensified if the entity's transactions are concentrated in one type of security. Changes in market prices may also result in over- or under-collateralization of the related borrowing. The auditor should understand the effect of changes in both the level and structure of interest rates on the client's financial position and should review the current market values, including

accrued interest, of securities serving as collateral to determine if the collateral is sufficient or excessive in relation to the contractual requirements of the loan.

Responding to Credit Risk. The auditor's principal concerns regarding the credit risk assumed by a client seller-borrower are (a) that the buyer-lender will not be able to complete the transaction by returning (selling back) the securities at maturity of the agreement, and (b) that the issuer of the securities pledged as collateral will default on interest or principal. The auditor's response to the latter risk is the same with regard to securities underlying RP-RRP agreements as it is with any other securities, and is therefore not addressed in this report. The risk that the buyer-lender will be unable to complete the transaction, however, is an additional risk in these types of transactions.

If there is reason to question the credit worthiness of the buyer-lender, the auditor of the seller-borrower may consult with legal counsel regarding whether, in the event of the buyer-lender's inability to return (sell back) the collateral securities, the seller-borrower has the legal right to setoff the loan liability against the collateral. If the seller-borrower is unable to reclaim the collateral in the event of the buyer-lender's bankruptcy and if the legal right of setoff exists, the seller-borrower's economic loss is limited to the amount by which the value of the collateral

also determine precisely which entity, within an affiliated group, the client is doing business with. The auditor should be particularly alert to the existence and possible effect of transactions between the dealer and parties related to it and the extent to which a registered broker-dealer may have net capital in excess of statutory requirements.

Responding to Control Risk. The seller-borrower may attempt to mitigate any or all of the risks it faces by instituting controls over RP-RRP transactions. Those controls include, but are not necessarily limited to, (a) the use of master agreements entered into by authorized personnel that specify the terms of the transactions and the intent of the parties, (b) policies and procedures to restrict trading activity with individual dealers and in specific types of securities, (c) the use of hedging techniques to reduce market risk, (d) monitoring communications with dealers and reviewing dealer confirmations for unrecorded or inappropriately recorded transactions and for the reasonableness of security prices and interest rates, (e) monitoring the market value of collateral as a basis for adjustments to amounts borrowed or securities collateralizing the borrowings, and (f) monitoring the reputation, financial stability, and credit worthiness of the buyer-lender as a basis for evaluating its ability to fulfill its obligation to return the collateral. The auditor may deem it appropriate to review, test, evaluate, and rely on some or all of those controls.

(plus accrued interest) exceeds the principal of the loan,* and accordingly the credit risk associated with the default of the other party is lower than would otherwise be the case. If, however, the legal right of setoff is not present, the seller-borrower's loss is potentially the full value of the securities. In either situation, the auditor should consider reviewing and testing the client's controls over evaluating the buyer-lender's financial stability and credit worthiness, or performing substantive tests that address the same audit objectives.

The auditor should consider the relevance and reliability of auditing procedures that may assist in assessing credit risk. The extent to which the client concentrates its reverse repurchase agreements with one dealer or a small group of dealers, whether those dealers are subject to reporting or regulatory requirements of one or more federal agencies, and the presence of audited financial statements all provide evidence helpful in evaluating credit risk.

If the buyer-lender is regulated, the auditor of the seller-borrower should review the latest audited financial statements and other available reports, such as the report on internal accounting control if that report discloses a material weakness or material inadequacy. The auditor should

*The accounting loss will differ from the economic loss if the book value of the collateral differs from its market value.

Auditing Accounts Reflecting Buying-Lending Transactions

This section discusses factors to be considered by auditors of entities that enter into agreements to buy and later resell the same or substantially the same securities (repurchase agreements).

Responding to Business Risk, Market Risk, Credit Risk, and Control Risk. Most of the risks faced by buyer-lenders that enter into repurchase agreements are also faced by seller-borrowers that enter into reverse repurchase agreements, although their relative importance will be different. Accordingly, the response to those risks by an auditor of a buyer-lender should also be similar to the response by an auditor of a seller-borrower, but with different degrees of emphasis. The categories of risk are similar because in both instances the client either owns securities or is committed to buy the same or substantially the same securities, and risks resulting from ownership of an asset are also present when an entity is obligated to purchase the asset. Accordingly, the earlier discussion of the auditor's response to a seller-borrower's business, market, credit, and control risks is relevant to an auditor of a buyer-lender that enters into repurchase agreements.

Responding to Risk of Collateral Loss. The collateral risk faced by buyer-lenders may differ from that faced by seller-borrowers. A buyer-lender that is not a government securities dealer may not take delivery of the

securities that serve as collateral. If it does, either directly or indirectly through its bank or other institution acting as agent, collateral risk is minimal; the auditor should count or confirm the securities, as appropriate. The auditor should also consider requesting the opinion of legal counsel as to the status of the collateral and the propriety (or legality) of the transaction.

If the collateral is held by the dealer but is "locked up" in safekeeping for the benefit of the buyer-lender, the securities will be segregated and identified by customer, and the buyer-lender's auditor can confirm their existence with the dealer. If the collateral is held by the dealer's bank or other custodian acting as the dealer's agent, the auditor should determine whether the dealer furnishes the custodian with the identity of the specific customers for whom the collateral is held. If it does, the auditor should confirm the details of the collateral with the custodian. If it does not, the auditor should view the repurchase agreement in the same way as if the dealer continues to hold the securities, namely, as an unsecured loan, and should confirm the dealer's obligation to repurchase the securities and evaluate its ability to do so, as noted above in the discussion on responding to credit risk.

In situations in which the existence of securities held by a custodian, including a dealer that segregates and identifies them, can be confirmed, the auditor should also

consider the extent to which the risk of collateral loss can be further reduced by obtaining a report from the custodian's auditor on the custodian's internal accounting controls over securities held in safekeeping, as indicated by Statement on Auditing Standards No. 44, Special-Purpose Reports on Internal Accounting Control at Service Organizations. That report should cover both the design of the system and compliance tests directed to specific objectives of internal accounting control over the custodial function. SAS No. 44 notes that circumstances may exist in which the auditor may need to discuss the custodian's auditor's procedures with him or her, request that specific tests be performed, or make such tests himself or herself.

CONCLUSIONS AND RECOMMENDATIONS

1. The task force reviewed existing Statements on Auditing Standards to ascertain whether they provide adequate guidance to auditors of entities that engage in repurchase-reverse repurchase (RP-RRP) transactions. The task force notes that auditing standards are measures of the quality of performance; they are not auditing procedures--steps to be performed with respect to the specific transactions and other events and circumstances of specific entities. We believe that existing Statements on Auditing Standards provide adequate and appropriate guidance for auditing RP-RRP transactions.

2. Audit and accounting guides illustrate the application of authoritative standards to specialized industries and specialized audit areas, for example, pension plans. After reviewing the guides or exposure drafts pertaining to banks, savings and loan associations, securities broker-dealers, state and local governmental units, insurance companies, investment companies, credit unions, and pension plans, the task force concluded that additional educational materials on auditing RP-RRP transactions should be added to those guides. The supplemental guidance should include, but not be limited to, the auditing considerations discussed earlier in this report and should be tailored to apply to the circumstances of the particular industry.

3. Whether viewed from an accounting, legal, economic, or purely mechanical perspective, RP-RRP transactions are extremely complex. It is doubtful whether any single person or organization--either a party to an RP-RRP transaction or an entity that provides services, including auditing services, to that party--has a complete understanding of how all of the possible varieties of RP-RRP agreements affect all of the parties to those transactions, nor is such an understanding needed to be able to conduct an effective, high quality audit of any one of those parties. It is likely that the complexity of new financial instruments that will surely

evolve in the future will make existing RP-RRP agreements appear simple by comparison. Consequently, the task force believes that a need exists for a comprehensive study of all existing financial instruments to provide guidance to auditors of parties to those instruments. That study should be part of an ongoing effort to monitor new financial instruments as they evolve, to alert the users of those instruments to the risks that they entail, and to provide guidance to auditors on how to respond to those risks. While it will be necessary to address those financial instruments, their risks, and their audit implications in separate audit and accounting guides for each affected party, we believe it may be efficient and educational if that effort were also undertaken and guidance provided by a single task force and in a single audit guide that would discuss those instruments from all appropriate perspectives. That task force would then be capable of providing auditing guidance on a timely basis in a way that would be comparable to that in which
the FASB Emerging Issues Task Force provides guidance on accounting issues posed by those instruments.

4. As this report indicates, the level of risk assumed by the various parties to RP-RRP transactions varies widely depending on the terms of the agreement, the parties to it, and its legal status. Here, as in all other financial and operating undertakings, there is a presumption that the

parties to those undertakings have the sophistication to enter into them wisely. There is also a presumption that the financial statements reflect both the risks of and the returns from those undertakings: the auditor's role is limited to judging whether that is in fact the case. It would be no more appropriate here than in other situations for the auditor to assume the primary responsibility for preparing the financial statements of the transacting parties or the notes thereto. The auditor is not, and should not be asked to be, a reporter of financial information.

Conceptually, the level of risk that exists in a given agreement should affect the financial statements in at least two ways: the classification and valuation of accounts reported on the face of the balance sheet, and the nature of the disclosures reported in the notes to the financial statements. Both of these are accounting issues that need to be addressed by accounting standard-setting bodies. The auditor's proper role, here as elsewhere, is to evaluate whether accounting measurements, classifications, and disclosures reflect, in conformity with generally accepted accounting principles, the substance of RP-RRP transactions and the various risks assumed. The level of risk in some (but not all) RP-RRP transactions may be sufficiently high, particularly if delivery of the collateral has not taken place* or if its

*The task force has observed that, in certain instances, technological, practical, and economic considerations may preclude the effective delivery of collateral in an RP-RRP transaction.

value is not monitored, that the proper way to account for them is as unsecured financing transactions, with full disclosure of the risks involved and of the legalities of the transactions. The appropriate accounting standard-setting bodies should consider requiring disclosure of, among other things, (a) each of the several risks assumed in the particular RP-RRP agreements entered into, (b) the amount by which the market value of the underlying securities in those agreements exceeds the cash proceeds (the "haircut"), and (c) the maximum potential accounting loss that could result.

5. Several commentators on the recent failures of government securities dealers have suggested that additional guidance might be necessary to assist auditors in identifying and auditing RP-RRP transactions involving related parties.

The task force believes that existing guidance provided by the section on "Related Parties" in Statement on Auditing Standards No. 45, _Omnibus Statement on Auditing Standards - 1983_, is adequate and appropriate. However, the task force recommends that an Interpretation* of SAS No. 45 be

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*The staff of the Auditing Standards Division has been authorized to issue Interpretations to provide timely guidance on the application of pronouncements of the Auditing Standards Board, whose members review the Interpretations. An Interpretation is not as authoritative as a pronouncement of the Auditing Standards Board, but auditors should be aware that they may have to justify a departure from an Interpretation if the quality of their work is questioned.

issued reminding practitioners that, because of the high risk inherent in related party transactions, they should examine sufficient competent evidence to be able to understand the business purpose and economic effects of sometimes complex related party transactions. (The task force has been advised that such an Interpretation is currently under preparation.)

SAS No. 45 also requires the auditor to obtain information about the financial capability of a related party when such information is necessary to fully understand a particular transaction, and notes that the auditor should determine the degree of assurance required and the extent to which available information provides such assurance. Ascertaining the financial capability of a related party or understanding the financial effect of a transaction not entered into at "arms length" may occasionally require the auditor to examine the financial statements of the related party or apply other procedures sufficient to meet those objectives.

In addition, SAS No. 45 notes the auditor's responsibility to determine the existence of related parties and the specific procedures that may be employed in doing so. If the client has not instituted procedures for identifying transactions with related parties, the auditor may wish to obtain representations from management and the board of directors about the existence of those transactions.

6. Several commentators have suggested that additional guidance might be necessary on the auditor's use of a special-purpose report on aspects of the internal accounting control of an organization that provides services, such as safekeeping and custodial services, for a client.

While the task force concluded that the existing guidance in SAS No. 44, Special-Purpose Reports on Internal Accounting Control at Service Organizations, is adequate and appropriate, the task force believes, as discussed under "Auditing Considerations," that if securities are earmarked or segregated, it may be appropriate for the auditor of a buyer-lender to obtain a report on controls instituted by a custodian over securities held in safekeeping for the buyer-lender. SAS No. 44 contains adequate guidance on the use of those reports, and accordingly the task force has no further recommendations in this area.

7. Several commentators have also suggested that additional guidance might be necessary on the use of confirmations in auditing RP-RRP transactions.

The task force believes that the auditing literature on the appropriate use of confirmation procedures is adequate. It also believes, however, that auditors should be mindful of the limited audit objectives about which the confirmation process provides evidence. Seller-borrowers that are not securities dealers generally transfer the securities that underlie RP-RRP transactions to the buyer-lenders, which need

not and usually do not keep them. The buyer-lenders trade the securities or use them for other purposes, which the rights of ownership permit. Accordingly, an auditor of a seller-borrower cannot confirm the existence or location of the underlying securities, but should confirm the transaction with the buyer-lender as evidence of its occurrence and terms and that the related collateral was delivered.

Ordinarily, an auditor of an entity engaging in RP-RRP transactions as a buyer-lender is able to confirm the existence of securities that serve as collateral and are held by third parties acting as agent for the buyer-lender. Buyer-lenders frequently neither take possession of the securities nor require that they be delivered to a custodial agent and identified as belonging to the buyer-lenders. In those cases, the auditor can request a confirmation of the seller-borrower's obligation to return the securities. A confirmation that the seller-borrower has segregated and identified securities generally will not diminish either collateral or credit risk unless the auditor also obtains an SAS No. 44 special-purpose report, either on internal accounting control or on the results of the application of agreed-upon procedures, and assesses the seller-borrower's financial viability and credit worthiness, as discussed in the body of this report. The task force does not believe that it is in the public interest to recommend, or request others to require, that buyer-lenders always take possession of the securities underlying RP-RRP transactions, primarily because of

the relatively high costs of doing so and the likelihood that the market for such instruments would be narrowed. The task force does recommend, however, that appropriate accounting standard-setting bodies consider whether the status of collateral in these circumstances should be a required financial statement disclosure.