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American Institute of Certified Public Accountants. Committee on Savings and Loan Associations

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August 7, 1979

Issues Paper

Accounting for Repurchase, Reverse Repurchase, Dollar Repurchase And Dollar Reverse Repurchase Agreements for Savings and Loan Associations

Prepared by

Committee on Savings and Loan Associations

American Institute of Certified Public Accountants

INTRODUCTION

1. The principal business activities of savings and loan associations (S&Ls) are the acquisition of funds, primarily through customer savings deposits, and the investment of the funds in long-term mortgage loans collateralized by real estate, principally residential. The major portion of such investments has been originated directly by S&Ls, as mortgagee, with the purchasers, as mortagor, of the real property. However, direct investment by S&Ls in the primary mortgage market does not necessarily result in the most efficient channeling of funds to the housing market, due to disparities in the supply of, and demand for, mortgage funds. Consequently, a secondary mortgage market was created, with the encouragement of government regulations, to eliminate such geographic disparities and to facilitate a more efficient flow of funds to the housing market by enabling S&Ls in areas with surplus funds to buy loans from S&Ls in areas with excess mortgage demand.

2. The creation of Government National Mortgage Association (GNMA) and Federal Home Loan Mortgage Corporation (FHLMC) in 1970 increased the participation of S&Ls in secondary mortgage market activities. Investments in GNMA pass-through certificates and FHLMC Participation Certificates (PCs) have characteristics common to investment securities. However, in the context of S&L operations GNMA and FHLMC securities are considered by S&Ls and the Internal Revenue Service to be investments in real estate loans. Furthermore,

federal regulatory authorities have likewise ruled that such securities are investments in real estate loans. Popular forms of investments acquired by S&Ls are repos, reverse repos, dollar repos (DR) and dollar reverse repos (DRR). These terms are defined in the following section on "Definitions."

3. Reverse repo transactions, particularly the dollar reverse type, have taken many complex forms and the applicability of existing accounting literature to such transactions is unclear. As a result, the accounting principles set forth in the section of this paper on "Authoritative and Other Literature" have been inconsistently applied in practice. This inconsistency has caused concern among the accounting profession, industry, and regulatory authorities. The regulatory authorities have requested clarification of existing accounting literature to eliminate the diversity of treatment for the types of investments noted in the preceding paragraph. This paper discusses the issues involved in accounting for the types of transactions being entered into by S&Ls.

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DIFINITIONS

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4. The following definitions apply for purposes of this paper. 6

Government National Mortgage Association (GNMA). A wholly owned corporate instrumentality of the United States government, which purchases, services, and sells mortgages insured or guaranteed by the Federal Housing Administration (FHA) and the Veterans Administration (VA) and may perform other secondary market functions to support the home mortgage market. The association is often referred to as "Ginnie Mae."

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Federal Home Loan Mortgage Corporation (FHLMC). The corporation was chartered by an act of Congress in July, 1970, for the purpose of assisting in the development and maintenance of a secondary market in conventional residential mortgages. The corporation purchases mortgages from financial institutions, the accounts of which are insured by an agency of the U.S. government. The corporation is often referred to as "Freddie Mac."

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Pass-through Certificates. Certificates guaranteed by GNMA representing shares in pools of mortgages insured by the FHA, VA or Farmers Home Administration. The individual pools include mortgages with the same interest rate and same approximate maturity. The payback to investors includes both interest and principal, both guaranteed by GNMA. There are minimum trading unit amounts.

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Mortgage Participation Certificates (PCs). Certificates representing undivided interests in specified residential conventional mortgages

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underwritten and owned by the FHLMC. The FHLMC unconditionally guarantees the payment of principal and interest.

Securities. The term, as used in this paper, is narrowly defined as GNMA pass-through certificates and FHLMC PCs. In the context of S&L operations, GMNA and FHLMC securities are considered to be investments in real estate loans.

Repurchase Agreement (repo). An agreement whereby an association purchases securities with a stipulation that the seller will repurchase the identical securities within a specified time at a specified price.

Reverse Repurchase Agreement (reverse repo). An agreement whereby an association sells securities with a stipulation to repurchase them within a specified time at a specified price.

Dollar Repurchase Agreement (dollar repo). An agreement whereby an association purchases securities with a stipulation that the seller will repurchase securities of the same agency other than the identical securities sold, within a specified time at a specified price.

Dollar Reverse Repurchase Agreement (DRR). A reverse repurchase agreement whereby an association (seller) agrees to repurchase and a buyer, or third party, agrees to deliver securities of the same agency that are not identical to the securities originally sold.

Fixed-coupon Dollar Reverse Repurchase Agreement. A dollar reverse repurchase agreement whereby an association (seller)

and a buyer, or third party, agree that delivery is guaranteed to be made with securities having the identical certificate interest rate as the securities sold.

Yield-maintenance Dollar Reverse Repurchase Agreement. A dollar reverse repurchase agreement whereby an association (seller) and a buyer, or third party, agree that delivery will be made with securities that will provide the association a yield that is specified in the agreement.

Right of Substitution Clause. A provision in some DRR contracts permitting the buyer or third party to deliver other than substantially identical securities.

Third Party. A party other than the buyer or seller, usually a broker/dealer in securities or a correspondent bank.

Par cap. A provision in some repurchase agreements limiting the repurchase price to a stipulated percentage of the face amount.

SCOPE

5. This paper is limited to a discussion of the issues relating to the accounting treatment for the various types of repurchase and reverse repurchase agreements involving GNMA pass-through certificates and FHLMC mortgage participation certificates entered into by S&Ls.

AUTHORITATIVE AND OTHER LITERATURE

6. The revised AICPA Audit and Accounting Guide for Savings and Loan Associations (S&L Guide) provides some guidance in the area of accounting for repo and reverse repo transactions. The guide indicates that repos "represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers [generally a bank, broker/dealer or other S&L] will repurchase the securities within a very short period of time, usually a few days." In addition, the S&L Guide addresses reverse repos and concludes:

> "In substance, these arrangements represent borrowings collateralized by the related securities. When funds are borrowed under this [type of] arrangement, a liability should be established for the amount of the proceeds. The investment security account should not be relieved of the collateral securities. Interest on reverse repos should be reported as an expense and not shown net of interest income."

7. The conclusions reached in the S&L Guide are supported by AICPA Statement of Position (SOP) 74-12, Accounting Practices in the Mortgage Banking Industry, which states that while the "loans transferred. . . may technically be sales, . . . the existence of a formal repurchase agreement. . . indicates that the risk of

market loss is retained by the [seller] and such transactions are essentially financing in nature and should be accounted for as such." Further support for these conclusions is provided in the AICPA Industry Audit Guide (IAG) Audits of Brokers and Dealers in Securities (Broker/Dealer Guide), which discusses repo transactions from the viewpoint of the other party (usually a broker/dealer) to these transactions. The primary difference is that the roles - and terms describing the transactions - are reversed. The Broker/Dealer Guide defines repos as "transactions involving the sale and delivery of securities with a simultanious agreement to repurchase them" (a reverse repo as defined by S&Ls) and concludes that "as a rule, these transactions. . . are another means of borrowing money."

8. In addition to the aforementioned publications dealing specifically with accounting for repos and reverse repos, the AICPA has issued the following publications dealing with revenue recognition in transactions subject to certain contract contingencies:

- IAG - Accounting for Retail Land Sales
- IAG - Accounting for Profit Recognition on Sales of Real Estate
- SOP 74-6 - Recognition of Profit on Sales of Receivables with Recourse
- SOP 75-1 - Revenue Recognition When Right of Return Exists
- SOP 78-8 - Accounting for Product Financing Arrangements

9. While those pronouncements do not deal specifically with the types of transactions discussed in this paper, the narrative and, particularly, the conclusions in them appear relevant to the issues covered in this paper. The applicability of such publications to the types of transactions discussed in this paper is supported, for example, by SOP 74-6 which concludes that other examples "may also be comparable in substance to transactions involving the sale of receivables. . .. In such cases, the concepts discussed in [SOP 74-6] regarding the recognition of profit arising from the sale of receivables with recourse are equally appropriate." A detailed summary of those pronouncements is provided in the appendix to this issues paper. Each of the pronouncements listed above is generally concerned with revenue recognition for transactions involving right of return provisions. These types of transactions are analogous to repo and reverse repo transactions in which securities are "bought" ("sold") and, in a concurrent agreement, "resold" ("repurchased") at some future date.

10. Furthermore, the primary issue in each of the pronouncements appears to be: Does a transaction involving right of return provisions constitute a sale or do the return provisions so restrict the seller's transfer of risk as to require some other method of accounting, for example, the financing method?

Criteria for distinguishing between a sale and a deferred sale or financing transaction are needed. The criteria are discussed at length both in the pronouncements and in the appendix to this paper; the pronouncements unanimously concur with paragraph 12 of SOP 75-1, which concludes that "To be accounted for as a sale, a transaction should transfer from the seller to the buyer. . .the usual risks of ownership. . .. Any risk that is retained by the seller in the asset sold should be limited essentially to that of a secured creditor. Otherwise, accounting for a transaction other than as a sale is required."

11. Inherent in the discussion in those pronouncements is the presumption that "the property" being "repurchased" is identical in all respects to the property (securities) "sold" subject to a recourse (repurchase) provision. In the S&L industry, however, the securities are often not identical in all respects to the original securities. The types of transactions involving securities that are not identical are referred to in this paper as dollar repos and dollar reverse repos. Authoritative literature specifically covering these types of transactions is virtually nonexistent. However, the principles set forth in the listed pronouncements and summarized in the appendix appear to be applicable to such transactions.

12. As noted in the introduction, federal regulatory authorities, principally the Federal Home Loan Bank Board (the Bank Board) and the Securities and Exchange Commission (SEC), have expressed to the accounting profession their concerns regarding accounting for repo and reverse repo transactions. The Director of the Bank Board has issued several "Memorandum to Staff" communicating the Board's opinion on accounting for these types of transactions.

13. Regarding repos, one memorandum observes that "the General Counsel [of the Bank Board] has concluded in an opinion that the type of transaction described above [Federal funds repo agreement] does not constitute a short-term investment in securities despite the nomenclature used, but is rather a secured loan transaction in which a Federal association is not authorized to engage." However, the memorandum continues:

> "Short-term investments in Government securities by a Federal association would be authorized, even though subject to a repurchase agreement, when the essential elements of a sale are present. For example, a repurchase transaction would be treated as a short-term investment rather than as a loan under the following conditions:
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> 1. The association purchasing the securities is entitled to physical possession of them;

2. The association is not required to deliver the identical securities in the event of repurchase;

3. The association assumes the risk of market fluctuation (either gain or loss or both) in the value of the securities it has purchased; and

4. The association receives the interest borne by the securities purchased, any differential between the coupon or stated rate of a security and the market rate being reflected by a discount or premium in the principal price at the time of purchase, with a further adjustment in the principal price (in the event of repurchase) to represent the appreciation or depreciation in the value of the security during the period it is owned by the association."

14. In another memorandum, the Director addressed reverse repos and concluded:

"Reverse repurchase agreement transactions are simply the 'selling' of securities subject to a repurchase agreement. While transactions entered into by associations may take various forms, the essence of a 'reverse repo' transaction

is the sale of securities, with an agreement that the selling association will repurchase them at a later date, for which the association receives funds from the 'purchaser' at an agreed upon rate of interest. As such, the transaction constitutes a borrowing. . .."

15. The SEC also addresses reverse repos in its Release No. IC-10666 on "Securities Trading Practices of Registered Investment Companies." The Commission concludes "that, in economic reality, the reverse repurchase transaction is a loan to an investment company [could be applied to S&Ls] by the other party, collateralized by the security, because all of the incidents of ownership of the security are retained by the. . . company. Furthermore, even if the form of the transaction were altered to reflect more closely an actual sale and repurchase of a Ginnie Mae instead of a transfer of a security in conjunction with a loan, the proceeds of the initial sale would still be considered to be a borrowing. . .."

16. The SEC also notes that ". . . companies may choose to engage in reverse repurchase agreements for two reasons. First, reverse repurchase agreements could be used to finance the purchase of interest bearing securities, allowing the . . . company to derive income from the interest rate differential between the costs of borrowing and the return on the security purchased with the proceeds. For example, [a] company would

purchase a Ginnie Mae. On settlement date, it would enter into a reverse repurchase agreement with the seller of the Ginnie Mae and use the proceeds obtained from the reverse repurchase agreement to reduce the amount owed on the purchase. The. . . company could thereby complete the purchase of the security by investing cash amounting to only 3-10% (typically) of the value of the security. The. . . company's objective would be, then, to realize net income on the differential between the yield it would receive from the Ginnie Mae and the interest it would pay for the use of the proceeds.

17. "Second, [a] company would enter into a reverse repurchase agreement with a Ginnie Mae it already owns. By so doing, it would obtain additional cash to invest in other securities. In such a case, the. . . company's objective would be, then, to obtain funds to pursue additional investment opportunities whose yield would exceed the carrying cost of the proceeds of the reverse repurchase agreement."

18. "In each of the above circumstances, the reverse repurchase agreement entered into by the. . . company constitutes a borrowing. . . ."

19. Thus, it appears that current regulatory requirements concur with existing professional accounting literature regarding the distinction between the sales and financing methods of accounting for repo and reverse repo transactions.

DIVERSITY IN PROFESSIONAL LITERATURE

20. The preceding section addressed the applicability of existing professional and regulatory pronouncements to the types of transactions discussed in this paper. Those pronouncements as they apply to S&Ls appear to limit the alternative methods of accounting for repo and reverse repo transactions to the financing method (referred to as the "deferred" or "delayed" recognition method in the professional pronouncements) and the buy/sell method (referred to as the "sales" or "immediate recognition" method in the professional pronouncements).

21. Furthermore, the professional pronouncements set forth definitive criteria for treating transactions subject to repurchase agreements as sales. The professional pronouncements conclude that use of the "sale" or "immediate recognition" method is appropriate only for transactions meeting all the criteria set forth in the pronouncements. All other transactions involving repurchase agreements would be accounted for as financing arrangements.

22. In summary, there appears to be no diversity in professional literature for reporting sales subject to repurchase agreements. There is general agreement that transactions meeting the sales criteria set forth in existing professional pronouncements should be treated as sales and that all other similar transactions not meeting the sales criteria should be accounted for as financing arrangements.

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DIVERSITY IN PRACTICE

Reverse Repos and Repos

23. The accounting profession, industry, and regulatory authorities apparently agree that the accounting principles discussed in the preceding section, "Authoritative and Other Literature," and in the appendix hereto are generally applicable to reverse repo and repo transactions.

24. Reverse repos. These types of transactions have been uniformly accounted for as borrowings collateralized by the related securities.

25. Repos. These types of transactions have been uniformly accounted for as loans.

26. Since there is apparent uniformity among the industry in applying GAAP to reverse repos and repo transactions, further discussions contained in this paper will be limited to dollar reverse repo and dollar repo transactions.

Dollar Reverse Repos and Dollar Repos

27. Dollar Reverse Repos. Currently, there are several alternative viewpoints regarding the classification of, and accounting for, DRRs, as illustrated in the table below:

Alternative	Classification and Accounting Treatment
A	All DRRs are accounted for as sell/ buy agreements.

B All DRRs are accounted for as financing arrangements.

C DRRs are identified as either "fixed-coupon" or "yield-maintenance" types and accounted for as either financing arrangements or sell/buy agreements.

28. The proponents of alternative A account for DRR transactions by relieving the investment securities account of securities sold, recognizing currently any gain or loss on them, and recording the purchase of the newly acquired securities as a separate transaction.

29. The proponents of alternative B account for DRRs as borrowings collateralized by the related securities. The securities account retains the securities "sold." A liability is recorded for the amount of proceeds of "sale," resulting in no gain or loss.

30. As noted in the table above, some proponents of alternative C treat the fixed-coupon types as financing arrangements and yield-maintenance types as sell/buy agreements. Others, while agreeing that there are two types of DRRs, believe that there should be no difference in accounting for either type of transaction. They account for both types of DRRs under either alternative A or B, based on their belief that such transactions more closely resemble sell/buy agreements or financing arrangements.

31. <u>Dollar Repos</u>. Similar diversity of application exists for dollar repos. Therefore, the foregoing discussion on DRRs is

appropriate for dollar repos except that DRs may be considered to be loans, whereas DRRs may be considered to be borrowings. Consequently, a further discussion of the alternative methods of accounting for dollar repos is considered unnecessary.

PROS AND CONS

32. As noted in the preceding section on authoritative literature, the key factor in distinguishing a sell/buy agreement from a financing arrangement in a dollar reverse repo transaction is the degree of risk retained by the seller. Furthermore, inherent in the determination of the degree of risk retention is the presumption that the property repurchased is the identical property sold under a concurrent agreement to repurchase. In the S&L industry, the parties to a dollar reverse repo agreement often accept delivery of securities that are not the identical securities originally sold. However, the parties agree that the delivered securities are "substantially identical" to the sold securities and, therefore, are "identical" for purposes of consummating the transaction.

33. Accounting literature generally concludes that the substance of a transaction is more significant than the legal form. This conclusion appears particularly applicable to dollar reverse repo transactions involving delivery of "substantially identical" securities. The determination of sale vs. financing largely depends on one's interpretation of the term substantially identical securities. This paper discusses the bases of those alternative interpretations and their impact on the basic issues. In practice, the interpretation of the definition of substantially identical securities has led to diversity in applying to DRR transactions

the accounting principles set forth in the existing authoritative literature. Specifically, the alternative viewpoints may be summarized as follows:

Fixed-coupon DRRs

34. Some believe that the fixed-coupon type of DRR, that is, a reverse repo involving securities bearing the idential certificate interest rate as the original securities and collateralized by a similar pool of mortgages, for example, single-family mortgages, constitutes a transaction involving substantially identical securities. As support for their viewpoint, they note that, in the GNMA market, securities with similar type collateralization and bearing the same contract interest rate are priced to result in substantially similar market values. Typically, GNMA prices or yields are not quoted to investors on the basis of yield to contractual maturity, that is, what the investors return would be if none of the pooled mortgages collateralizing the GNMA certificate were prepaid but were paid down in accordance with the contractual amortization schedule. The method used for determining prices or yields on GNMA securities quoted to investors is based on an assumption of a certain level of prepayment on the pooled mortgages. For example, in the case of single-family mortgage loans, prices or yields are quoted to investors equivalent to that of a single loan that amortizes according to a prescribed thirty-year amortization schedule and achieves prepayment of the

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balance in the twelfth year. Although this method does not recognize the fact that different pools of mortgages do have varied maturities, it has provided a uniform method of quoting prices or yields to investors that is broadly accepted in the GNMA market.

35. Notwithstanding the preceding arguments in support of their position, proponents of the foregoing treatment support the view that a fixed-coupon DRR containing a "right of substitution clause" does not constitute a transaction involving substantially identical securities due to the inherent uncertainty over the type of security to be repurchased.

36. On the other hand, some argue that the existence of contract provisions permitting delivery of a certificate collateralized by a separate, but similar, mortgage pool and having a potentially different yield to maturity is not a substantially identical security. Those holding this view do not accept the argument that a security having an identical contract interest rate is substantially identical to a security collateralized by another separate, but similar, pool of mortgages.

Yield-maintenance DRRs

37. Those supporting the view that yield-maintenance DRRs do not constitute transactions involving substantially identical securities observe that, in a yield-maintenance DRR, the buyer is obligated only to deliver a certificate at a yield agreed upon at the time the DRR was executed. Therefore, the securities may

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- be represented by different certificates,
- be backed by separate, but similar, mortgage pools,
- bear different contract interest rates,
- have different principal amounts, and
- leave the seller at risk in the market place.

In addition, proponents of this alternative believe that those entering into such transactions (1) are divorced of market opportunities with respect to such securities and (2) may not know, at the time of sale, the contract interest rate, since current GNMA interest rates vary depending upon current FHA mortgage rates. As further support for their position, proponents of this view note the following differentiating characteristics of secondary market certificates:

- The price spread relationships between securities with different contract interest rates do not move in tandem, providing opportunities for the buyer or third party to have considerable flexibility in the GNMA marketplace to select securities for delivery to the S&L that provide the greatest benefit to the buyer or third party at the time of delivery and within the parameters of the yield-maintenance type DRR agreement.

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- The existence of a par cap, as defined, could significantly alter the economics of the transaction.

38. The cumulative effect of these differences between the sold securities and the repurchased securities is, according to these proponents, significant enough to preclude such securities from being considered substantially identical. In addition, continuous rollovers of securities resulting in repurchasing of constantly changing certificates could ultimatley result in a repurchased security, once considered substantially identical, that is <u>no longer</u> deemed substantially identical for the reasons outlined above.

39. Finally, proponents of this view on yield-maintenance DRRs may be divided on the issue of fixed-coupon DRRs. Some believe that fixed-coupon DRRs meet the definition of substantially identical securities, while others believe that they do not.

40. In contrast, some believe that the arguments put forth in the preceding paragraphs concerning yield-maintenance DRRs are, in many instances, not material to the overall transaction. Accordingly, they believe the securities delivered under this type of DRR meet the criteria of substantially identical securities. Futhermore, proponents of this view argue that there is no intrinsic difference between fixed-coupon and yield-maintenance DRRs. As a

result, those holding this view also support the conclusions reached by those who hold that fixed-coupon DRRs should be accounted for as financing arrangements.

PRESENTATION OF THE BASIC ISSUES

41. The basic issues discussed in this paper are as follows:

- Does a fixed-coupon DRR, that is, the selling of a GNMA (FHLMC PC) and the concurrent agreement to repurchase a certificate that is not identical in all respects but that bears the same certificate interest rate and is collateralized by a pool of similar mortgages, constitute a DRR transaction involving substantially identical securities and, therefore, a financing arrangement?
- Does a yield-maintenance DRR, that is, the selling of a GNMA (FHLMC PC) and the concurrent agreement to repurchase a certificate that is not identical in all respects and that bears a different certificate interest rate but carries the same yield and is collateralized by a pool of similar mortgages, constitute a DRR transaction involving substantially identical securities and, therefore, a financing arrangement?

OTHER ISSUES

42. Other issues that may affect the accounting treatment of DRR transactions are:

- Does a rollover/extension of an original dollar reverse repo contract constitute an event requiring accounting recognition?
- Does the repurchase of a principal amount different from the principal amount of securities "sold" have any accounting implications when a DRR is treated as a financing arrangement?

43. Some believe that a rollover/extension represents a separate economic transaction that must be accounted for independently of the accounting treatment given the original contract. Opponents of this view argue that a rollover/extension merely represents a continuation of the original contract and, therefore, does not constitute an economic event for accounting purposes.

44. It is common practice in the secondary mortgage market to accept repurchased securities with a principal amount that varies from the principal amount of securities originally sold under the agreement. Furthermore, it is generally accepted "on the street" that a "good" delivery is one in which the principal amount of the repurchased securities is within 2-1/2% (plus or minus) of the principal amount of the sold securities.

45. If the principal amount of the repurchased securities is

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greater than the principal amount of the sold securities, there is 5
general agreement in the industry that the excess cost represents 6
an additional investment in securities and should be accounted for 7
accordingly. However, if the principal amount of the repurchased 8
securities is less than the principal amount of the sold securities, 9
there is diversity of treatment. 10

46. Some make no entry to reflect the reduction in principal 11
amount on those DRRs treated as financing arrangements. This 12
treatment results in a higher cost being assigned to a smaller 13
unit of investment. 14

47. Others record the repurchase by removing the proportionate 15
share of the "sold" securities, including the pro rata unamor- 16
tized original premium (discount), from the accounting records 17
and by recognizing the resulting gain or loss on disposition 18
immediately. This has the effect of reducing the investment 19
portfolio to the actual cost of the repurchased securities. 20

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ADVISORY CONCLUSIONS

48. The following are the conclusions of the AICPA's Committee on Savings and Loan Associations on the basic and other issues presented in the preceding sections; the Accounting Standards Executive Committee unanimously agrees with these conclusions.

- The fixed-coupon type of DRR represents a transaction involving substantially identical securities and, therefore, represents a collateralized financing arrangement for financial reporting purposes. A liability should be recorded for the amount of proceeds of the "sale" and the "sold" securities should not be removed from the accounting records. The differential in selling price and repurchase price should be recorded as interest expense, ratably over the term of the repo agreement, and not netted against interest income. Amortization of original premium (discount) and interest income on the "sold" securities should continue to be recorded as though the securities had not been sold.

  The Committee voted unanimously in favor of this conclusion.

- The yield-maintenance type of DRR does not represent a transaction involving substantially identical securities and, therefore, represents two individual transactions - a sale of one type of securities and a purchase of another type of

securities. The sold securities, including unamortized premium (discount), should be removed from the accounting records and the resulting gain or loss recognized immediately. The commitment to purchase securities should be appropriately disclosed in the financial statements. The newly acquired investment should then be recorded at cost.

The Committee voted unanimously in favor of this conclusion.

- Rollovers/extensions of DRR contracts represent transactions requiring accounting recognition. Such transactions should be accounted for based on facts and circumstances at the time of the rollover/extension. For example, the rollover at maturity of a fixed-coupon DRR into another financing arrangement. The rollover at maturity of a fixed-coupon DRR into a yield-maintenance DRR would, however, give rise to a different accounting treatment. Although the fixed-coupon DRR transaction may be treated as a financing arrangement, the rollover into a yield-maintenance DRR would require recognition of gain or loss under the sell/buy method of accounting.

The committee voted unanimously in favor of this conclusion.

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- If the principal amount of the securities repurchased is greater than the principal amount of those originally sold, the cost of the repurchased securities in excess of amounts previously recorded should be recorded in the investment securities account as though a separate acquisition of additional investment securities had occurred. If the principal amount of the securities repurchased is less than the principal amount of those originally sold, the investment securities account should be relieved of the proportionate share of securities that, in reality, have been sold and any gain or loss, adjusted for the pro rata share of unamortized premium (discount), should be recorded immediately.

The Committee voted unanimously in favor of this conclusion.

APPENDIX

Other Accounting Literature

49. The section entitled "Authoritative and Other Literature" summarizes the conclusions of certain AICPA publications considered relevant to the issues contained in this paper. The publications referred to in that section are as follows:

Industry Audit Guide - Accounting for Retail Land Sales

Industry Audit Guide - Accounting for Profit Recognition on Sales of Real Estate

Statement of Position 74-6 - Recognition of Profit on Sales of Receivables with Recourse

Statement of Position 75-1 - Revenue Recognition When Right of Return Exists

Statement of Position 78-8 - Accounting for Product Financing Arrangements

50. A more detailed discussion of the issues and conclusions contained in those publications is provided in the following paragraphs.

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Statement of Position 74-6

51. SOP 74-6 defines two methods of accounting for sales of receivables with recourse. They are the "delayed recognition method" and the "immediate recognition method."

52. Paragraph 20 of the statement outlines a comparison between the delayed recognition method and a financing arrangement ("borrowing treatment") and concludes that "much of what is said in [SOP 74-6] about the delayed recognition method applies to the borrowing treatment [as defined in the statement] because of the similarity they both share in their accounting result for profit recognition and in their basic assumption, i.e. that the sale of receivables with recourse is primarily a financing transaction." The statement indicates that proponents of the immediate recognition method believe that, notwithstanding the financing characteristics of the transactions, sales of receivables are completed transactions. The statement discusses the attributes of each method and concludes:

> "Sales of receivables with recourse have significant characteristics of financing transactions in which monies are borrowed and assets are pledged as security thereon. This conclusion is based on the fact that the seller's risks are retained by the recourse provision which also effectively pledges his assets as security for the sum advanced by the

buyer. The differential represents primarily the difference between the value of the interest on the receivables sold and the value of the interest on the funds advanced by the buyer. The interest rate at which the buyer is willing to advance funds to the seller reflects the fact that risks are retained by the seller and also reflects his credit standing. These considerations are implicit in a lending transaction. The Division [AICPA Accounting Standards Division] therefore concludes that the use of the delayed recognition method is preferable to the use of the immediate recognition method."

53. The foregoing conclusion is based primarily on the fact that the seller's risks are retained by virtue of the recourse provision.

Statement of Position 75-1

54. The significance of the risk retention provision in such transactions is addressed in SOP 75-1 dealing with revenue recognition when right of return exists. As discussed in that SOP, the key issue appears to be:

> In those circumstances involving a buyer's right of return is the transaction a sale or does the existance of a return provision sufficiently limit the transfer of the seller's risks and, therefore, negate the sale?

55. The SOP notes that a "seller may retain significant risks if there is a right to return the property" and that following "the accounting treatment accorded in certain other situations in which risks are retained, it may not be appropriate to record the transaction as a sale until circumstances assure that the buyer will not return the property." Paragraph 27 provides the following rationale supporting the "non-sale" treatment.

- "Transactions in which the buyer has an unconditional right of return may be in substance consignments and should be accounted for as such.
- "Where significant risks of ownership are retained by the seller, objective, verifiable evidence regarding amounts ultimately to be realized as sales proceeds usually cannot be obtained."

Among the risks pointed out in SOP 75-1 that might be retained by the seller is an "arrangement that provides for a return resulting from option of buyer to compel seller to repurchase product (in this case, security)." This type of transaction closely resembles reverse and dollar reverse repos.

56. Alternatively, recording these types of transactions as sales may be appropriate and paragraph 28 of SOP 75-1 provides the following arguments in favor of such treatment.

- "When a sale takes place, frequently many risks are retained by the seller even if the property will not be returned. For example, the retention of a credit risk often includes the retention of risks of ownership in the property sold. . ..
- "The delivery of property to a buyer, even though subject to return at a later date, is often a significant economic event which entails agreement by the buyer to accept the property and frequently involves passage of title. Thus, it is an event which has an effect on the cash-generating ability of the seller, measurement and reporting of which is considered an important objective of financial statements.

o "If a loss occurs in a subsequent period which was not reasonably forseeable, it should be given accounting recognition in the period in which it occurs as an economic consequence of activities of that period. A loss which was not reasonably forseeable should not preclude recognition of a sale."

57. The SOP notes that the "choice between these two accounting alternatives [sale vs. non-sale] appears to be highly dependent upon the degree to which returns can be predicted" and reaches the following conclusions:

"The Division [AICPA Accounting Standards Division] believes that sales transactions should be analyzed to determine their economic substance. If the seller is exposed to the risks of ownership through return of the property, it should be presumed that the transactions should not be recognized currently as sales unless all of the following conditions are met (and the usual conditions for recording sales not involving right of return have also been satisfied):

- "The seller's price to the buyer is substantially fixed or determinable at the date of exchange.
- Either the buyer has made full payment, or the buyer is indebted to the seller and payment is not contractually or implicitly excused until such time as the product is resold.
- The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the property.
- The buyer acquiring for resale has economic substance apart from that provided by the seller; that is, the buyer is not a straw party or conduit.
- The seller does not have significant obligations for future performance to bring about resale of the property by the buyer.
- The amount of future returns can be reasonably predicted."

Industry Audit Guides - Retail Land Sales and Sales of Real Estate

58. In support of its conclusions, SOP 75-1 refers to the conclusions of two IAGs, Accounting for Retail Land Sales and Accounting for Profit Recognition on Sales of Real Estate. The latter provides the following guidance for ascertaining that a sale has occurred.

59. Paragraph 11 notes that "Economic substance should determine the timing of recognition, amount, and designation of revenue if the economic substance of a transaction differs from its legal form. . . . For example, a transaction that is in the legal form of a sale. . . may be in economic substance. . . a deposit on or an option to purchase the asset. . . ."

60. Paragraph 12 continues, "To be accounted for as a sale, a transaction should transfer from the seller to the buyer (a) the usual risks of ownership (for example, obsolescence, unprofitable operations, unsatisfactory performance, idle capacity and dubious residual value). . . . Any risk that is retained by the seller in the asset sold should be limited essentially to that of a secured creditor. Otherwise, accounting for a transaction other than as a sale is required."

Paragraph 36 of the Guide states the following:

> "The Committee [AICPA Committee on Accounting for Real Estate Transactions] concludes that the following contractual provisions. . .

require accounting for the transaction as a financing, leasing, or profit sharing arrangement:

> "A seller has an obligation or an option to repurchase the property. . ..
> A buyer has an option to repurchase the property. . ..
> A seller guarantees the return of the buyer's investment. . .."

Statement of Position 78-8

61. SOP 78-8, Accounting for Product Financing Arrangements, further supports the criteria established for reporting a transaction as a sale. The type of arrangements covered by SOP 78-8 are those in which a "sponsor" (seller, in the case of reverse repo transactions):

a. "Sells a product [security] to another entity (the company through which the financing flows), and in a related transaction agrees to buy the product [security] back.

b. "Is a party to an arrangement whereby an entity purchases a product [security] on the sponsor's [seller's] behalf, and the sponsor [seller] in a related transaction agrees to buy the product [security] from the entity."

62. As in the previously mentioned literature, SOP 78-8 concludes that it "is necessary to determine whether the company [S&L] that 'sells' the product [security], and in a related transaction agrees to repurchase the product [security], has in substance transferred the risks and rewards of ownership of the product [security]. Based on that determination, a decision can be reached on whether the transferor should account for the transaction as a sale or as a financing transaction."

63. The SOP also outlines "characteristics that [may] exist

in product financing [repurchase] arrangements" as follows:

a. "The entity that purchases the product [security] from the sponsor [seller] or acquires it directly from a third party on behalf of the sponsor [seller] was established expressly for that purpose. . ..

b. "The product [security] covered by the financial arrangements is to be used or sold by the sponsor [seller], although a portion may be sold by the other entity directly to third parties.

c. "The product [security] subject to the financing [repurchase] arrangement is stored on the premises of the sponsor [seller]."

d. "The debt of the other entity is guaranteed by the sponsor [seller]."

64. The SOP concludes that the "sponsor [seller] of a product financing [repurchase] arrangement that demonstrates all of the characteristics described in paragraph 4 [of SOP 78-8] bears substantially all of the risks and rewards of ownership of the product. The assets and related liabilities that result from such product financing [repurchase] arrangements should be reported in the financial statements of the sponsor [seller]."

65. Furthermore, "products [securities] and obligations

under product financing arrangements that contain all the characteristics described in paragraph 4 [of SOP 78-8] should be accounted for by the sponsor [seller] as follows:

a. "If a sponsor [seller] sells a product [security] to another entity and, in a related transaction, agrees to buy back the product [security]. . . the sponsor [seller] should record a liability at the time the proceeds are received from the other entity to the extent that the product is covered by a financing [repurchase] arrangement. The sponsor [seller] should not record the transaction as a sale and should not remove the product [security] from its balance sheet. . .. Such a product financing arrangement, despite its form, does not in substance represent a sale or purchase by the sponsor [seller], but rather a method of financing. . .. "

b. "If the sponsor [seller] is a party to an arrangement whereby an entity buys a product [security] on the sponsor's [seller's] behalf and, in a related transaction, the sponsor [seller] agrees to buy the product [security] from the entity, the sponsor [seller] should record the asset and the related obligation when the product [security] is acquired by the other entity."