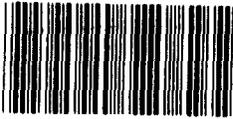


126120  
3/10/85

UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548



126730

FOR RELEASE ON DELIVERY  
EXPECTED AT 10 A.M.  
APRIL 17, 1985

STATEMENT OF  
FREDERICK D. WOLF, DIRECTOR  
ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION  
BEFORE THE  
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS  
OF THE  
HOUSE COMMITTEE ON ENERGY AND COMMERCE  
ON  
AUDIT STANDARDS AND PROCEDURES  
RELEVANT TO AUDITS OF  
FINANCIAL INSTITUTIONS INVOLVED IN  
SIGNIFICANT GOVERNMENT SECURITIES REPURCHASE AGREEMENTS

Mr. Chairman and Members of the Subcommittee:

You have requested that we outline for your subcommittee today those audit standards and procedures which are relevant to an audit of a financial institution involved in significant government securities repurchase agreements with unregulated government securities dealers. As you requested, we have limited ourselves to a review of the existing professional literature and our professional experience with financial audits in general.

031823

As I testified at your hearing on February 20, the objective of an independent audit is to express an opinion on the fairness with which a company's financial statements and related disclosures provide a full and fair view of an organization's financial position and results of operations. Independent audits must follow a set of generally accepted auditing standards and must be properly performed by competent professionals applying their professional judgment in the circumstances existing in the specific company being audited.

As I noted then, auditing standards are general in nature and often do not provide specific audit techniques or methodology. Auditor judgment, knowledge of the organization to be audited and the industry or environment in which it operates and other factors form the basis on which auditors develop specific audit procedures and steps. The elements of materiality and relative risk underlie the application of all standards and procedures; that is, the more material or risky areas are subjected to more rigorous tests and procedures than areas of limited import or risk. Auditing standards differ from auditing procedures in that procedures relate to acts to be performed whereas standards deal with measures of the quality of performance of those acts.

Auditing standards are promulgated through the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA). This board interprets generally accepted auditing standards through 'Statements on Auditing Standards' to

assist auditors in the performance of their work, and also issues 'Industry Audit Guides' and other materials which provide guidance in certain specific industries. The statements on auditing standards and related industry guides have been summarized in several comprehensive compendia. The statements on auditing standards issued by the AICPA, the AICPA's savings and loan, banking, and brokerage audit guides as well as some other recognized compendia have served as the primary basis for our analysis of relevant standards.

It is important to identify the basic characteristics of the entity being audited before discussing the standards and specific procedures involved in any particular examination. You have asked us to focus on the standards and practices relevant to the examination of assets, collateral and liabilities related to government securities repurchase and reverse repurchase agreements of a financial institution having a material amount of such transactions, substantially all of which are being transacted through a single outside institution. Our work in responding to your question did not include a review of any specific organization or audit; we have confined ourselves to expressing our professional judgement on the standards and procedures we consider applicable in the general circumstance described above.

As I indicated, there are both generally accepted auditing standards and specific audit procedures which must be considered. Let me first address standards.

While all of the ten audit standards promulgated by the American Institute of Certified Public Accountants are relevant to some degree, I would like to focus on those which have particular relevance to the circumstances cited above.

- 1) The examination is to be performed by persons having adequate technical training and proficiency as an auditor. This standard would apply both to the individuals assigned to the job as well as the availability of appropriate industry expertise in the audit firm.

As I think was amply demonstrated in your last hearing, the repo and reverse repo markets involve complex financial transactions. The individuals assigned to an engagement either need to bring to it an adequate understanding of these complex transactions or they need to avail themselves of expertise available in their firm (or outside) to insure an appropriate understanding of the implications of these transactions.

Adequate training and proficiency are critical since only through a thorough understanding of these transactions, coupled with a good grasp of the objectives of the audit in this area, can an auditor begin to design appropriate audit procedures.

- 2) There must be a study and evaluation of existing internal control as a basis for reliance thereon and to determine the extent of audit tests required. Every major area of a company's business should have an internal control system to safeguard its assets and to reasonably insure the accuracy and reliability of financial reports. This system of internal control must be studied by the auditor in order to enable the auditor to establish a basis for reliance thereon in determining the nature, extent and timing of the specific audit procedures to be performed.
- 3) Sufficient evidential matter must be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for the auditors opinions on the financial statements. The extent and type of evidence to be collected and evaluated on a specific job are two of the primary considerations on which an auditor exercises his professional judgement. The specific procedures to be developed and implemented by the auditor should result in obtaining sufficient competent evidence.
- 4) Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the auditors report. Full and fair disclosure must be made in the financial statements of all significant facts relevant to the reader of

financial statements. The auditor evaluates the adequacy of disclosures based on all of his work and knowledge of a particular area of the audit. If disclosures are not correct, adequate and complete, the auditor must so state in his report.

With these standards in mind, I would like now to turn to the audit objectives and the specific audit procedures which appear to be relevant to an examination in the circumstances we are discussing.

The objectives of the audit work on these repo accounts are:

- 1) to determine the existence, ownership and rights of ownership to the assets, including collateral rights, and liabilities and commitments reported in the financial statements,
- 2) to determine that those assets and liabilities have been properly valued, and
- 3) to determine that there has been appropriate presentation and disclosure of those items in the financial statements.

In order to achieve these objectives, in the circumstances we have defined, the following procedures should be employed:

- 1) A review of the appropriate internal controls utilized by the financial institution to safeguard its assets and ensure the reliability of its financial records.

Because of the relative magnitude of the repo transactions and the concentration of them with one outside organization, the functions performed by that

outside organization may be considered to be a part of the financial institution's own internal accounting control system and may, therefore, be subject to study by the clients' auditors.

The outside organization, in this case, the unregulated government securities dealer, operating under either a general or specific authorization given by the client organization, may execute transactions and maintain related accountability and asset control over which the client organization may not have acceptable direct control. If the client's auditor decides that it is either necessary or efficient to rely on the internal accounting control procedures of an outside organization, the auditor should either obtain the outside organization's auditor's report on the design and compliance of the systems based specific internal accounting control objectives, or the auditor should perform the review himself.

In other words, if the company being audited uses the services of another organization to process significant transactions and hold significant assets and collateral, the audit firm should consider having the auditor of that outside organization review the internal controls and report to them the results of such review. The AICPA has issued a statement on auditing standards which specifically covers these

types of reports on internal accounting controls at service organizations.

In some ways this is analogous to the situation which has been around for a long time concerning inventories held in public warehouses. Generally, direct confirmation of the inventory would provide adequate evidence to validate the existence and ownership of the inventory. However, if the inventories held by the outside warehouse are material, confirmation should be supplemented by one or more of the following procedures:

- a) Review and test the clients control procedures for investigating the warehousemen, including tests of related evidential matter.
- b) Observe the warehouseman or client's count of goods.
- c) If warehouse receipts have been pledged as collateral, confirm pertinent details of the pledged receipts.
- d) Obtain and review an independent auditor's report on the warehouseman's system of internal accounting control relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable.

It is interesting to note that those procedures were instituted in the 1960's primarily as a result of the New Jersey salad oil scandal, a situation involving missing customer inventories and pledging of customer inventory for debts of the warehouse.

- 2) Based upon the review of internal control, the following audit steps should be employed at or as of the balance sheet date:
  - a) Review the specific contract to determine the operating criteria under which the parties must operate.
  - b) Confirm account balances and related individual item details including repurchase agreement details and collateral or segregated securities with the financial institutions or other outside party holding the assets, collateral and liabilities. These confirmations must then be reconciled to the books and accounts of the company. If collateral is held by a separate party, then separate confirmation of that collateral and its segregation or commingled nature should be performed if the collateral is material.
  - c) Determine that any subsidiary ledgers agree with general ledger control accounts.
  - d) Vouch or test to original source documents a representative sample of the individual transactions to determine that they had been appropriately authorized in accordance with management

criteria, are adequately documented and are properly recorded in the accounts.

- e) Test the valuation of securities to published market prices or relevant repurchase agreements.
- f) Because of the magnitude of these transactions and the potential credit risks involved, it would appear that a review of the outside financial institution's related disclosures and auditors report thereon would be warranted.
- g) Depending on the degree of reliance to be placed on the work of another auditor, and the materiality of the related transactions, the principal auditor may want to perform one or more of several procedures designed to determine the professional reputation and standing of the auditor, or the scope or quality of his work.
- h) Although not technically required by the professional literature at the current time, there has been a fair degree of discussion within the profession as to the advisability of meeting with federal or state bank examiners, or reviewing their reports. If they have been recently involved in an examination of the financial institution being audited, this would be done to ascertain whether there are matters that should be considered by the auditor. We believe this is an appropriate procedure.

- i) Review the reporting of the repo accounts in the financial statements and the related footnote disclosures to insure they are complete and accurate, and that they properly portray all the relevant information including major concentrations of transactions with individual dealers.
- j) Finally, we believe two types of quality checks are appropriate beyond the normal supervision and review exercised on the audit, namely:

--referencing, usually by an individual who did not work on the audit, of the report to the underlying workpapers to ensure that the report and financial statements are adequately supported in the workpapers, and

--an independent review of the overall quality, conduct of the audit, and the audit report itself by a second partner not directly involved in the audit.

\* \* \*

Having said all of the above, I would remind the committee that there are no specific procedures which are applicable in every instance and that alternative procedures to those listed above might be employed by an auditor. The point is, it is incumbent upon the auditor to understand the nature of the client's business and the related risks associated with that

business and transactions and to design appropriate tests to achieve the objectives of determining the existence, ownership and control over the assets and liabilities reflected in the financial statements and to insure that they are properly valued, presented and disclosed.

This concludes my statement. I would be pleased to answer any questions the Committee might have.