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SUBJECT:	ACCOUNTING AND FINANCIAL REPORTING FOR CERTAIN INVESTMENTS AND FOR EXTERNAL INVESTMENT POOLS			

TO: All State Agencies

FROM: Accounting Bureau - Department of Administration

INTRODUCTION

This management memo establishes State accounting policy for the recording and disclosing of investments in accordance with generally accepted accounting principles (GAAP) as promulgated by GASB Statement #31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools. GASB 31 amends Statement 2, Financial Reporting of Deferred Compensations Plans Adopted under the Provisions of Internal Revenue Code Section 457, Statement 3, Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements, and Statement 28, Accounting and Financial Reporting for Securities Lending Transactions by replacing the term market value with **fair value**. It also amends paragraphs 40, 41, 44, 46, and 47 of Statement 10, Accounting and Financial Reporting for Risk Financing and Related Insurance Issues and, for governmental funds, supersedes paragraphs 64 through 67 of Statement 11, Measurement Focus and Basis of Accounting-Governmental Fund Operating Statements, the implementation of which has been indefinitely postponed. GASB 31 also amends Management Memo (MM) 2-88-1. GASB 31 applies to all state and local governmental employers, including governmental hospitals, colleges, public employee retirement systems, etc.

TERMINOLOGY*

ASSET-BACKED SECURITIES - Assets that are composed of, or collateralized by, loans or receivables. Collateralization may consist of liens on real property, leases, or credit card debt.

CHANGE IN FAIR VALUE OF INVESTMENTS - Difference between the fair value of investments at the beginning of the year and at the end of the year, taking into consideration purchases, sales, and redemptions.

CLOSED-END MUTUAL FUND - An SEC-registered investment company that issues a limited number of shares to investors which are then traded as an equity security on a stock exchange. See also Open-end mutual fund.

DEBT SECURITY - Any security that represents a creditor relationship with an entity. It also includes (a) preferred stock that either is required to be redeemed by the issuing entity or is redeemable at the option of the investor and (b) a collateralized mortgage obligation (CMO) or other instrument that is issued in equity form but is accounted for as a nonequity instrument. It excludes option contracts, financial futures contracts, and forward contracts.

- Thus, the term *debt security* includes, among other things, U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, convertible debt, commercial paper, negotiable certificates of

deposit, securitized debt instruments (such as CMOs and real estate mortgage investment conduits - REMICs), and interest-only and principal-only strips.

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- Trade accounts receivable arising from sales on credit and loans receivable arising from real estate lending activities of proprietary activities are examples of receivables that do not meet the definition of a security; thus, those receivables are not debt securities. (If, however, they have been securitized, they would then meet the definition.)

EQUITY SECURITY - Any security that represents an ownership interest in an entity, including common, preferred, or other capital stock; unit investment trusts; and closed-end mutual funds. However, the term equity security does not include convertible debt or preferred stock that either is required to be redeemed by the issuing entity or is redeemable at the option of the investor.

EXTERNAL INVESTMENT POOL - An arrangement that pools the monies of more than one legally separate entity and invests, on the participants' behalf, in an investment portfolio; one or more of the participants is not part of the sponsor's reporting entity. An investment pool that is sponsored by an individual state or local government is an external investment pool if it includes participation by a legally separate entity that is not part of the same reporting entity as the sponsoring government.

FAIR VALUE - The amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

INDIVIDUAL INVESTMENT ACCOUNTS - An investment service provided by a governmental entity for other, legally separate entities that are not part of the same reporting entity.

INTEREST-EARNING INVESTMENT CONTRACT - A direct contract, other than a mortgage or other loan, that a government enters into as a creditor of a financial institution, broker-dealer, investment company, insurance company, or other financial services company and for which it receives, directly or indirectly, interest payments. These type of contracts include time deposits (such as certificates of deposit), repurchase agreements, and guaranteed and bank investment contracts (GICs and BICs).

INTERNAL INVESTMENT POOL - An arrangement that pools the monies of more than one fund or component unit of a reporting entity.

INVESTMENT - A security or other asset acquired primarily for the purpose of obtaining income or profit.

MONEY MARKET INVESTMENT - A short-term, highly liquid debt instrument such as commercial paper, banker's acceptances, and US Treasury and agency obligations.

OPEN-END MUTUAL FUND - An SEC-registered investment company that issues shares of its stock to investors, invests in an investment portfolio on the shareholders' behalf, and stands ready to redeem its shares for an amount based on its current share price. New shares are created to meet investor demand and the value of the investment in the fund depends on the value of the underlying portfolio.

OPTION CONTRACT - A contract that gives the owner the right, if they choose, to purchase from (call option) or sell to (put option) the seller of the contract a fixed number of items, such as shares of equity securities, at a fixed determinable price at any time on or before a specific date.

PARTICIPATION - The ability of an investment to capture interest rate changes through the investment's negotiability or transferability.

RESTRICTED STOCK - Equity securities whose sale is restricted at acquisition by legal or contractual provisions (other than in connection with being pledged as collateral) unless the restriction terminates within one year or the holder has the power to cause the requirement to be met within one year.

SECURITY - A transferable financial instrument that evidences ownership or creditorship, whether in physical or book entry form.

SPONSORING GOVERNMENT - A governmental entity that provides investment services to other entities and has a fiduciary responsibility for those investments.

STOCK RIGHTS - Rights given to stockholders to purchase newly issued shares in proportion to their holdings at a specific date.

STOCK WARRANTS - Certificates entitling the holder to acquire shares of stock at a certain price within a stated period.

STRUCTURED NOTES - Debt securities whose cash flow characteristics (coupon, redemption amount, or stated maturity) depend on one or more indexes, or that have embedded forwards or options.

2A7-LIKE POOL - An external investment pool that is not registered with the SEC as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's rule 2a7 of the Investment Company Act of 1940 (17 Code of Federal Regulations §270.2a-7). 2a7-like pools are allowed to use amortized cost rather than market value to report net assets to compute share prices if certain conditions are met.

*GASB Statement 31, Glossary

GENERAL DISCUSSION

GASB 31 establishes accounting and reporting standards for ALL investments held by governmental **external investment pools** and for the following investments when held by governmental entities other than external investment pools, deferred compensation (IRC 457) plans, and defined benefit pension plans:

1. **Interest-earning investment contracts.**
2. External investment pools.
3. **Open-end mutual funds.**
4. **Debt securities.**
5. **Equity securities, option contracts, stock warrants, and stock rights** that have readily determinable fair values. Equity securities include unit investment trusts and closed-end mutual funds.

NOTE: Investments not specifically included in GASB 31 should be reported as current guidance dictates.

According to GASB 31, the investments listed above, along with all investments held by governmental external investment pools, should be accounted for at **fair value** in the balance sheet or other statement of position. The fair value of the investments listed in 5 above is considered to be readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the Securities Exchange Commission (SEC) or on the over-the-counter market. The prices or quotations for the over-the-counter market are required to be publicly reported by the National Association of Securities Dealers Automated Quotations systems (NASDAQ) or the National Quotation Bureau. When the investments listed in 5 above are traded in a foreign market only, fair value is considered to be readily determinable if the foreign market is of a breadth and scope comparable to the NASDAQ or the National Quotation Bureau. The fair value of restricted stock is not considered to be readily determinable.

Investments that are not subject to GASB 31, such as real estate or venture capital, should be reported at cost (or amortized cost, if applicable) when held by governmental entities other than external investment pools, defined benefit pension plans, or IRC Section 457 deferred compensation plans.

For governmental entities other than external investment pools, **money market investments** and certain participating interest-earning investment contracts may be reported at amortized cost when maturing within one year or less at the time of purchase, as long as the investment is not affected by the issuer's credit standing or by other factors. Money market investments do not include **asset-backed securities**, derivatives, or **structured notes**.

Nonparticipating contracts, such as nonnegotiable certificates of deposit, should be reported using a cost-based measure, rather than fair value, provided that the value of the investment is not significantly affected by the financial institution's credit standing or other factors. The fair value of investments in open-end mutual funds should be determined by the fund's current share price. An investment position held in a 2a7-like pool should be reported based on the pool's share price.

The State of Montana currently has four Public Entity Risk Pools (PERPs) that follow the guidance of GASB 10: 1) Hail Insurance, 2) Subsequent Injury, 3) State Compensation Insurance (New Fund), and 4) State Compensation Insurance (Old Fund). GASB 31 amends GASB 10 by requiring that the following investments held by PERPs be accounted for at fair value:

1. Bonds where there is the ability and the intent to hold until maturity.
2. Preferred stocks that are required by their provisions to be redeemed by the issuer if the pool has the ability and the intent to hold until redemption.

Defined benefit pension plans and certain deferred compensation plans should report the fair value of investments in:

1. Securities subject to purchased put option contracts and call option contracts.
2. Open-end mutual funds.
3. External investment pools.
4. Interest-earning investment contracts.

GASB 31 does NOT apply to (a) investments in equity securities that are accounted for under the equity method (APB Opinion #18) or (b) investments in joint ventures or component units (GASBS #14). It also does not apply to securities or other instruments when they are not held by the government for investment purposes.

GASB 31 amends MM 2-88-1, *Expendable and Nonexpendable Trust Funds*. MM 2-88-1 requires trust fund revenues be recorded first in the earning fund, with routine distributions of the revenue recorded as a transfer-out of the trust fund and a transfer-in to the receiving fund. GASB 31 requires that legal or contractual provisions be followed when assigning investment earnings. For example, if statute requires investment earnings of one fund be deposited in the General Fund, the earnings will be deposited as revenue in the General Fund rather than as a transfer from the fund that reports the investment. However, if investment earnings are assigned to another fund for other than legal or contractual reasons, i.e., a management decision, the investment earnings should be recognized in the fund that reports the investment. In this case, the provisions of MM 2-88-1 should be followed.

ACCOUNTING AND REPORTING REQUIREMENTS

REPORTING AT TRANSITION

The effective date of GASB 31 is for reporting periods beginning after June 15, 1997. Any accounting changes necessary to implement GASB 31 should be applied retroactively by restating the financial statements for all prior periods that are presented, if practical. If restatement of the financial statements is not practical, the beginning fund balance or retained earnings for the earliest period presented should be restated. The following are examples of the entries required in the year of implementation to restate fund balance or retained earnings:

To record an *increase* in the fair value of the participant's investment in the Trust Fund Bond Pool (TFBP) caused by implementation of GASB 31 (this one-time only entry should be made by the agency):

TFBP Appreciation/Depreciation (C/A 1628)	\$350,000	
Fund Balance (C/A 4xxx)		\$350,000

To record an increase in the fair value of the TFBP investment held in the agency fund (this entry is entered by the Board of Investments and does not have any effect on the agency entry above):

TFBP Appr./Depr. (C/A 1628)	\$580,000	
Accountability for Pool Appr./Depr. (C/A 2548)		\$580,000

NOTE: Agencies preparing comparative financial statements will need to restate fiscal year 1997 beginning fund balance for fiscal years 1996 and earlier and restate the appropriate investment control accounts for any appreciation/depreciation that occurred during fiscal year 1997.

ACCOUNTING ENTRIES

Agencies that administer their own investments (higher ed, MDC) will need to record the change in the fair value of investments as follows:

To record an increase in the fair value of long-term investments administered by agencies:

LT Investments Administered by Agencies Appr./Depr. (C/A 1647)	\$3,500	
Investment Appr./Depr. Income (C/A 51xx, Rev. Class 1300)		\$3,500

A decrease in the fair value of long-term investments administered by agencies would be the opposite of the previous entry.

The Board of Investments will need to record the **change in the fair value of investments** as follows:

To record an increase in the fair value of the participants' investment in the Trust Fund Bond Pool:

TFBP Appreciation/Depr. (C/A 1628)	\$92,000	
Investment Appr./Depr. Income (C/A 51xx, O/R 0014)		\$92,000

To record a decrease in the fair value of long-term corporate securities (C/A 1608):

Investment Appr./Depr. Income (C/A 51xx, O/R 0014)	\$54,000	
L/T Debt Securities Appr./Depr. (C/A 1648)		\$54,000

The Board of Investments will also need to record the change in the fair value of investments in the investment agency fund as follows:

To record an increase in the fair value of participants' investment in long-term corporate securities:

L/T Debt Securities Appr./Depr. (C/A 1648)	\$225,000	
Accountability for Pool Appr./Depr. (C/A 2548)		\$225,000

The following entries should be made by the Board of Investments in the investment trust fund (A/E 08501) for the investment in STIP held by local governments:

To record the asset and fund balance (year of implementation):

Local Govt. Participant's STIP Investment (C/A 1633)	\$1,025,000	
Reserve for External Pool Participants (C/A 4411)		\$1,025,000

To record receipt of contributions by local governments:

Cash (C/A 1104)	\$160,000	
Collection for STIP Purchases (Revenue Class 2610)		\$160,000

To record purchase of STIP for local governments:

Local Govt. Participant's STIP Investment (C/A 1633)	\$160,000	
Cash (C/A 1104)		\$160,000

To pay out earnings to local governments:

Local Government STIP Disbursements (O/E 7801)	\$25,000	
Cash <u>or</u> Due to Local Governments (C/A 1104 <u>or</u> 2540)		\$25,000

The Board of Investments will also need to record interest earnings, securities lending (SL) collateral, SL liability, SL revenues, SL expenses, receivables, payables, and administrative costs associated with the investment trust fund.

REPORTING

According to GASB 31, all investment income, including changes in the fair value of investments, should be recognized as revenue in the operating statement or other statement of activities. Investment income includes interest income, dividend income, realized gains and losses, and the change in the fair value of the investments. When the change in the fair value of investments is presented separately from investment income on the operating statement, as allowed but not required by GASB 31, it should be titled, Net Increase (Decrease) in the Fair Value of Investments. Realized gains and losses should not be presented separately from the Net Increase (Decrease) in the Fair Value of Investments, but may be listed separately in the notes to the financial statements.

For balance sheet presentation, the appreciation/depreciation C/As should be combined with the corresponding investment C/As, i.e., Long-term Corporate Securities (C/A 1608) should be combined with Long-term Corporate Securities Appr./Depr. (C/A 1648) to report the investment in corporate securities at fair value.

NOTE DISCLOSURES

Paragraph 15 of GASB 31 requires that the following investment disclosures be made in the notes to the financial statements:

1. The methods and assumptions used to estimate the fair value of investments, if the fair value is based on other than quoted market prices.
2. The policy for determining any investments that are reported at amortized cost.
3. For any investments in external investment pools that are not SEC-registered, a description of any regulatory oversight for the pool and whether the fair value of the position in the pool is the same as the value of the pool shares.
4. Any involuntary participation (participation required by law) in an external investment pool.
5. If an entity cannot obtain information from a pool sponsor to allow it to determine the fair value of its investment in the pool, the methods used and assumptions made in estimating the fair value and the reasons for making such an estimate.
6. Any income from investments when the income from one fund has been assigned to another fund.

If an entity chooses to disclose, in the notes, any realized gains and losses (computed as the difference between the proceeds of the sale and the original cost of the investments sold) or an external investment pool chooses to report any realized gains on its operating statement, the following should also be disclosed:

1. That the calculation of realized gains and losses is independent of the calculation of the net change in the fair value of the investments.

2. That any realized gains and losses on investments that were held in previous fiscal year(s) but sold in the current fiscal year were included as a change in the fair value of investments reported in the previous year(s) as well as the current year.

INTERNAL INVESTMENT POOLS

The equity position in internal pools should be reported as an asset in each fund or component unit as required by current practice.

EXTERNAL INVESTMENT POOLS

All investments held by external investment pools must be accounted for at fair value with the exception of short-term investments that have a remaining maturity of 90 days or less at the financial statement date. These investments, as well as investments in 2a7-like pools, may be reported at amortized cost. GASB 31, paragraph 62, requires that 2a7-like pools operate in a manner consistent with rule 2a7 and that the pool's policy reflect those requirements. The Accounting Bureau requires any external pool operating as a 2a7-like pool submit a copy of the pool's policy for annual review.

GASB 31, paragraph 17, requires that separate or stand-alone financial reports for external investment pools include a Statement of Net Assets and a Statement of Changes in Net Assets prepared on the economic resources measurement focus and the accrual basis of accounting. The following disclosures are required in addition to the requirements previously listed:

1. A brief description of any regulatory oversight (including whether the pool is registered with the SEC as an investment company).
2. The frequency of determining the fair value of investments.
3. The method used to determine participants' shares sold and redeemed and whether that method differs from the method used to report investments.
4. Whether the pool sponsor has provided or obtained any legally binding guarantees during the period to support the value of shares.
5. The extent of involuntary participation in the pool, if any.
6. A summary of the fair value, the carrying amount (if different from fair value), and the number of shares or the principal amount, ranges of interest rates, and maturity dates of each major investment classification.

In addition to the above, if the financial report distinguishes between the different components of investment income, i.e., interest, dividends, and other income, the pool should identify the accounting policy for defining each of the components it reports.

The State of Montana (through the Board of Investments) is considered to be the government sponsor of an external investment pool (STIP). The external portion of an external pool is required by GASB 31 to be accounted for in an Investment Trust Fund, a new category of fiduciary fund. The sponsoring government is required to present a Statement of Net Assets and a Statement of Changes in Net Assets for each Investment Trust Fund. The difference between the assets and the liabilities in the Statement of Net Assets should be titled net assets held in trust for pool participants. The internal portion of an external pool should be accounted for in the same manner as other internal investment pools.

CLOSING

Questions regarding this management memo should be directed to the Department of Administration, Accounting Bureau, at 444-3092.