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SUBJECT DISCLOSURE REQUIREMENTS FOR INVESTMENTS

TO: All State Agencies

FROM: Accounting Division - Department of Administration

INTRODUCTION

This management memo establishes State accounting policy to allow the reporting of investments in the State's Comprehensive Annual Financial Report (CAFR), in accordance with the Governmental Accounting Standards Board's (GASB) Statement #3, Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements and Technical Bulletin #87-1, Applying Paragraph 68 of GASB Statement 3. These disclosures may also be required in audited financial statements of each State agency or component unit (e.g., Board of Housing). A memo dealing with disclosures for deposits will be issued at a later date. (The Accounting Division will provide photocopies of GASB's Statement #3 and Technical Bulletin #87-1 at the expense of the requesting agency.)

GENERAL INFORMATION

Governmental entities generally invest in U.S. government and federal agency and instrumentality obligations and other types of securities. Methods of safeguarding these investments include: (1) having the securities held by a custodian or registered in the entity's name; (2) having broker-dealer insurance coverage; and (3) investigating the creditworthiness of issuing and custodial counterparties.

Governmental investors may hold securities themselves or entrust them to a broker-dealer, agent or trust department, or an independent third-party custodian. In addition, the investor may safeguard ownership of securities by having the securities registered in the investor's name. If securities are not registered or have been endorsed in blank by the registered owner, they become negotiable by anyone who has them. Securities in this form make transactions easier because they can be bought, sold, or transferred in less time and with less paperwork. However, because they are so easily negotiable, risks associated with them increase.

GASB Statement #3 provides criteria for disclosing and reporting investments and their associated risks. Statement #3 divides risk into three clearly defined categories (see RISK CATEGORIES on p. 3).

DEFINITIONS

Agent: Financial institution or broker-dealer that is a custodial agent only. If the financial institution or broker-dealer is both the entity's counterparty and custodial agent, its identity as the counterparty takes precedence in classifying securities in the risk categories.

Carrying Amount (Book Value): The amount at which assets and liabilities are reported in the financial statements.

Counterparty: Another party to a transaction. In the case of deposits and investments made by governmental entities, a counterparty could be the issuer of a security, a financial institution holding a deposit, a broker-dealer selling securities, or a third party holding securities or collateral. A financial institution or broker-dealer that acts as a purchasing agent by acquiring securities for an entity is considered a counterparty.

Entity: State of Montana and/or any component unit (e.g., a State agency, Board of Housing, Montana Economic Development Board, etc.)

In the name of the entity: Establishes the entity's rights to the securities.

Insured security: Securities held in customer accounts by Securities and Exchange Commission (SEC) registered broker-dealers may be insured by the Securities Investor Protection Corporation (SIPC). If a member broker-dealer fails, SIPC provides protection for customer accounts by returning securities registered in the name of the investor, distributing all remaining customer assets on a pro rata basis and providing SIPC funds for all remaining claims for each customer up to a maximum of $500,000, including up to $100,000 on claims for cash. Also, many broker-dealers have additional insurance above SIPC coverage.

Registered Security: A security that has the name of the owner written on its face. A registered security cannot be negotiated except by the endorsement of the owner.

Repurchase Agreement: An agreement in which a governmental entity (buyer-lender) transfers cash to a broker-dealer or financial institution (seller-borrower); the broker-dealer or financial institution transfers securities to the entity and promises to repay the cash plus interest in exchange for the same securities. Income from these agreements should be recorded as interest income.

Reverse repurchase agreement: An agreement in which a broker-dealer or financial institution (buyer-lender) transfers cash to a governmental entity (seller-borrower); the entity transfers securities to the broker-dealer or financial institution and promises to repay the cash plus interest in exchange for the same securities. Any assets or liabilities arising from these agreements should not be netted on the balance sheet. These agreements must be shown as a fund liability captioned "Obligations under reverse repurchase agreements" (C/A 2514), and the underlying securities should be reported as "Investments". The associated interest cost should be recorded as interest expenditure/expense and should not be netted with interest earned on any related investments. Income from these agreements should be recorded as interest income.

Trust department: Trust departments of financial institutions such as commercial banks, savings banks, and savings and loan associations. Assets held by those trust departments are held strictly on a fiduciary basis. Safekeeping departments are not considered trust departments, since safekeeping departments do not have any control over assets in their possession except for physical access to those assets.

Underlying securities: Securities transferred in accordance with a repurchase-reverse repurchase agreement.

Yield maintenance repurchase-reverse repurchase agreements: A dollar repurchase-reverse repurchase agreement in which the parties agree that the securities returned will provide the seller-borrower with a yield as specified in the agreement. These should be accounted for as purchases and sales of investments, with gains or losses recognized on the investments.

RISK CATEGORIES

The carrying amount of all investments must be classified into one of the three following risk categories (see Schedule 2 on p. 6).

Category 1: Insured securities, registered securities or uninsured, unregistered securities held by the entity or its agency in the entity's name.

Category 2: Uninsured, unregistered securities held by the counterparty's trust department or agent in the entity's name.

Category 3: Uninsured, unregistered securities held by the counterparty, or by its trust department or agent but not in the entity's name.

NOTE: Generally, investments in pools (e.g., STIP or MONTCOMP) managed by other governments or in mutual funds (e.g., Deferred Compensation) should be disclosed but not categorized because they are not evidenced by securities that exist in physical or book entry form.

Example 1: The entity instructs its broker to purchase $800,000 of U.S. Government securities. The broker holds the securities in its safekeeping account and identifies them in its internal records as owned by the entity. The broker is a member of the Securities Investor Protection Corporation (SIPC) and, thus, its customers' accounts are insured to $500,000. In this situation, the government should classify $500,000 of its investment as insured (Category 1) and $300,000 as uninsured and unregistered, with securities held by the counterparty (Category 3).

Example 2: The entity instructs a financial institution that is not a member of SIPC to purchase $800,000 of U.S. government securities. The financial institution's trading department purchases the securities and they are held by the financial institution's trust department. The trust department's internal records identify the securities as owned by the entity. The entity should classify the entire amount as uninsured and unregistered, with securities held by the counterparty's trust department in the entity's name (Category 2). However, if those securities are held in the financial institution's safekeeping department, even if held in the name of the entity, the entire amount should be classified as uninsured and unregistered, with securities held by the counterparty (Category 3).

REQUIRED INVESTMENT DISCLOSURES

General

In addition to risk categorization, Statement #3 requires disclosure of the following:

1. The types of investments authorized by legal (those arising from constitutions, charters, ordinances, resolutions, governing body orders and intergovernmental grant or contractual obligations) or contractual provisions and any significant violations of those provisions during the reporting period.

2. The carrying amount and market value of investments (including repurchase agreements) as of the balance sheet date in total and for each type of investment.

3. If the amount of an entity's "Uninsured, unregistered securities held by the counterparty, or by its trust department or agent but not in the entity's name" during the period <u>significantly</u> exceeded the amounts in those categories as of the balance sheet date, that fact and the causes should be briefly stated. (<u>EXAMPLE</u>: Disclosure is required if it is an entity's practice to leave securities underlying overnight repurchase agreements with the seller-borrower and the entity had a significant investment in these agreements at midyear due to peak cash flows but few investments involving similar risks at year-end).

4. The types of investments made during the period but not owned as of the balance sheet date.

5. Losses recognized during the period due to default by counterparties to investment transactions and amounts recovered from prior period losses.

<u>Repurchase-reverse repurchase agreements</u> (NOTE: These disclosures are in addition to disclosures 1 through 5 above):

6. For commitments as of the balance sheet date to resell securities under yield maintenance repurchase agreements, the carrying amount and market value as of the balance sheet date of the securities to be resold and a description of the terms of the agreements.

7. For commitments as of the balance sheet date to repurchase securities under yield maintenance agreements, the market value as of the balance sheet date of the securities to be repurchased and a description of the terms of the agreements.

8. If reverse repurchase agreements were used during the period, the entity should state the source of legal or contractual authorization for the use of those agreements and any <u>significant</u> violations of those legal or contractual authorizations.

9. The credit risk related to reverse repurchase agreements other than yield maintenance agreements outstanding as of the balance sheet date.

10. Losses recognized during the period due to default by counterparties to reverse repurchase agreements and amounts recovered from prior period losses.

<u>Agency Responsibilities</u>

The Board of Investments will be responsible for compiling the required disclosures on all investments under their control for each of the following classifications:

(a) Short-term investments: C/As 1603, 1605, 1607, 1609 and 1645*;
* Total market value is also needed for this C/A.

**(b) Equity in pooled cash and investments: C/As 1613, 1621 and 1645;
**Only carrying amount and market value are required for pooled investments and the securities on loan.

(c) Long-term investments: C/As 1601, 1602, 1604, 1606, 1608, 1610, 1625, 1644***, 2501 and 2512.
***Total market value is needed for this C/A.

Any agency with investments in the following control accounts will be responsible for compiling the required disclosures for each classification:

(a) Short-term investments: C/A 1640

(b) Long-term investments: C/A 1641

(c) Deferred Compensation: C/As 1615, 1616 and 1619

Required disclosures must be submitted to the Accounting Division by August 31 of each fiscal year in the following order (use N/A if any item is not applicable):

(a) Disclosures numbered 1, 3, 4 and 5 on p.4;

(b) If the agency had any repurchase or reverse repurchase agreements, then address disclosures numbered 6 through 10 on pg. 4;

(c) For disclosure number 2 (carrying amount and market value) any agency with investments in the control accounts listed above must provide two schedules for short-term investments and two for long-term investments (i.e., do not combine short-term with long-term investments);

(1) Schedule 1 (example below is not all inclusive) must contain a horizontal listing of security types and a vertical listing by accounting entity of the carrying amount and the market value for each of the security types listed horizontally.

	Government Securities	Corporate Bonds	Mortgages	Totals
A/E 02XXX:				
Carrying Amount	$ 100,000	$ 150,000	$ 200,000	$ 450,000
Market Value	125,000	165,000	200,000	490,000
A/E 06XXX:				
Carrying Amount	100,000	150,000	200,000	450,000
Market Value	135,000	175,000	200,000	510,000
A/E 09XXX:				
Carrying Amount	100,000	150,000	200,000	450,000
Market Value	145,000	175,000	200,000	520,000
TOTALS:				
Carrying Amount	$ 300,000	$ 450,000	$ 600,000	$ 1,350,000*
Market Value	$ 405,000	$ 515,000	$ 600,000	$ 1,520,000**

(2) Schedule 2 (example below is not all inclusive) must allocate each security type's carrying amount according to the category of risk as defined under RISK CATEGORIES (i.e., Category 1, Category 2 and/or Category 3).

	Category 1	Category 2	Category 3	Carrying Amount	Market Value
Government Securities	$150,000	$100,000	$ 50,000	$ 300,000	$ 405,000
Corporate Bonds	450,000	0	0	450,000	515,000
Mortgages	0	0	600,000	600,000	600,000
TOTALS	$600,000	$100,000	$650,000	$1,350,000*	$1,520,000**

The total carrying amount (*) and market value (**) in Schedule 1 must tie to the total carrying amount and market value, respectively, in Schedule 2.

NOTE: The following additional information must accompany the above schedules:

(a) The basis for the carrying amount of each security type (i.e., cost, amortized cost, etc.);

(b) If the type of security is a CD (Time Savings Certificate), indicate the collateralization that backs the CD.

CLOSING

Please call the Accounting Division at 444-3092 if you have any questions about this management memo.