

[Completely Superseded]

## IMPLEMENTATION GUIDE

Guide to Implementation of  
GASB Statement 3 on Deposits  
with Financial Institutions,  
Investments (including  
Repurchase Agreements), and  
Reverse Repurchase Agreements

Questions and Answers



**Governmental Accounting Standards Board**  
of the Financial Accounting Foundation

[Completely Superseded]

## **GASB IMPLEMENTATION GUIDES**

Guide to Implementation of GASB Statement 3 on Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements: Questions and answers (GQA01)

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This Implementation Guide discusses certain laws and regulations and market operations. This material is not intended to provide legal interpretations or an exhaustive discussion of these important matters. Where possible, the Implementation Guide directs readers to the original material or sources so they may obtain more complete information.

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## FOREWORD

This Guide to Implementation of GASB Statement 3 on Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements (Implementation Guide, or guide) is the first in a continuing series of question and answer (Q&A) publications. This guide was specifically developed to aid financial statement preparers in the implementation and application of GASB Statement No. 3, Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements, and Technical Bulletin No. 87-1, Applying Paragraph 68 of GASB Statement 3.

Since these documents were released, there have been a number of questions posed to GASB staff regarding the application of Statement 3 provisions. Because staff responses to individual technical inquiries reach only a small portion of the GASB's constituents, the GASB adopted the implementation guide concept to broaden the application of staff guidance. The GASB's Implementation Guides are classified in category (d) of the American Institute of Certified Public Accountants (AICPA) hierarchy of generally accepted accounting principles. The AICPA's Statement on Auditing Standards (SAS) No. 69, *The Meaning of "Fairly Presented in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report*, provides that level (d) includes "practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry or knowledgeable application to specific circumstances of pronouncements that are generally accepted." SAS No. 69 specifically states in the "Application to State and Local Governmental Entities" section that "category (d) includes implementation guides ('Qs and As') published by the GASB staff. . . ." To be classified in category (d), the effective date of this Q&A publication is March 16, 1992.

This guide was prepared and published in accordance with the GASB's Implementation Guide procedures. In summary, these procedures require public announcement of the project, exposure of the proposed Implementation Guide to the Board and an advisory group, and approval of the final guide by the director of research. Moreover, an Implementation Guide will not be published if a majority of Board members object to its issuance.

During the review of the draft Implementation Guide, three topics were identified that resulted in direct Board input before the guide's release. Guidance on the first topic, securities lending, was withdrawn from the guide. GASB staff believe that several issues related to securities lending transactions require additional research before guidance is provided. The Board agreed with this position and added a project on this subject to its technical agenda.

The second topic resulted from the Board's desire to reconsider the classification of trust agent transactions when a bank's trust department is a counterparty to a transaction and also serves as the custodian of the related securities under the provisions of a trust agreement. Although the GASB believes that the guidance provided in question 36 is appropriate within the confines of the current authoritative literature, the Board agreed to add a project to its technical agenda on applying Statement 3 to trust arrangements. The Board also agreed to additional staff research on the final topic, bank holding company affiliate transactions. However, it should be noted that a separate agenda item was not added and the Board did not request any modification to the guidance provided in question 37 at this time.

The publication of this guide could not have been accomplished without the efforts of the GASB staff and the advisory group. Venita M. Wood, GASB project manager, served as the lead author with assistance from Maurice P. Leger, GASB postgraduate intern. Ms. Wood served as assistant project manager on Statement 3, participated in the research on Technical Bulletin 87-1, and has fielded technical inquiries on Statement 3-related issues for the past six years. Mr. Leger, now with the accounting firm of Coopers & Lybrand, assisted with development of the guide and Statement 3 inquiries during his internship at the GASB.

The application of GASB pronouncements is an ongoing process. A guiding principle in GASB's mission statement addresses the need to review the effects of past decisions and to provide additional guidance when appropriate. This staff Implementation Guide represents just one of the many methods that the GASB uses to fulfill this important responsibility.

Norwalk, Connecticut  
December 1991

David R. Bean  
Director of Research

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## PREFACE

This Implementation Guide is intended to be both a learning tool and a ready reference. The material is presented in a question-and-answer (Q&A) format. Most of the Q&As were developed from technical inquiries received by the GASB staff on GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, and GASB Technical Bulletin No. 87-1, *Applying Paragraph 68 of GASB Statement 3*. In responding to these technical inquiries, the GASB staff finds that constituents better understand the answers given when the staff explains the concepts and reasoning underlying the responses. Therefore, many of the Q&As in this Implementation Guide are designed to present concepts. Many of the Q&As also discuss application in specific situations. Understanding Statement 3's concepts and the application of those concepts in specific situations will allow preparers to apply the material in this Implementation Guide to their specific implementation problems.

The Q&As in this Implementation Guide are organized based on the general topics in Statement 3. Sometimes, the Q&As build on material discussed in answers to other questions. Therefore, users of this guide are advised that they may need to read an entire section to fully understand the answer to a specific question. Where necessary information is presented outside of the section in which an answer is presented, cross-references have been provided.

To allow its use as a reference tool, this Implementation Guide includes a topical index to help users locate the GASB staff position on a particular issue. Also, Appendix 1 presents two series of questions that may be helpful in classifying many deposit and investment transactions in accordance with the requirements of Statement 3. A glossary and a list of acronyms, abbreviations, and documents also are included as appendixes for reference. The full text of the Standards section of Statement 3 and the questions and responses of TB 87-1 also are included in this Implementation Guide.

Some of the information in this Implementation Guide will become dated because regulations affecting a government's deposit and investment transactions often change. Therefore, users are advised that this Implementation Guide considers laws, regulations, and practices existing as of September 1991. Further, because the provisions of Statement 3 need not be applied to immaterial items, *all issues addressed in this Implementation Guide are assumed to be material*.

This Implementation Guide benefited from the comments of members of an advisory group who reviewed drafts of this report and assisted with research questions. The advisory group members were:

<b><u>Member</u></b>	<b><u>Affiliation</u></b>
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Membership on this group does not mean that these individuals or their organizations are responsible for the accuracy of the information included in this Implementation Guide or that they approve of or agree with any of the answers given.

GASB staff member Ellen Falk provided editorial assistance and GASB government fellow Jaimie L. Soulvie provided technical review assistance in preparing this Implementation Guide. The authors also appreciate the research and review assistance given by various other individuals and organizations.

Venita M. Wood  
Maurice P. Leger

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## IMPLEMENTATION GUIDE

### Guide to Implementation of GASB Statement 3 on Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements

#### Questions and Answers

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The Governmental Accounting Standards Board has authorized its staff to prepare GASB Implementation Guides that provide timely guidance on issues encountered during the implementation and application of GASB pronouncements. The GASB has reviewed this Implementation Guide and does not object to its issuance.

The provisions of this Implementation Guide are effective for financial statements issued after March 16, 1992. Earlier application is encouraged.

## QUESTIONS AND ANSWERS

### Background

1. Q—Why did the Governmental Accounting Standards Board (GASB) undertake a project on deposit and investment disclosures?

A—During the early 1980s, some local governments suffered losses on investments in repurchase agreements with government securities dealers that went bankrupt. One fact common in these repurchase agreement losses was that the dealers, through their custodial agents, retained possession of the securities underlying the agreements. Some governments also suffered losses related to the use of reverse repurchase agreements. The GASB added a project to its technical agenda to address the accounting and financial reporting for repurchase and reverse repurchase transactions.

The GASB found similarities between repurchase agreement risks and safeguards and those related to other investments and deposits, and expanded the project to address disclosures about all deposits and investments. The GASB's efforts resulted in the issuance of Statement No. 3, Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements, in April 1986.

2. Q—What is the purpose of the information that Statement 3 requires governments to disclose in their financial statements?

A—Statement 3 applies the financial reporting objective of disclosing risks of potential loss of resources as stated in [GASB Concepts Statement No. 1, *Objectives of Financial Reporting*, paragraph .179c<sup>1</sup>]. Statement 3 disclosures provide financial statement users with information to help them assess some of a government's actual and potential future deposit and investment market and credit risks.

Market risk is the risk that the value of an investment will decline. Credit risk is the risk that a counterparty to an investment transaction will not fulfill its obligations. Credit risk can be associated with the issuer of securities, with a financial institution holding deposits, or with a custodian of investment or collateral securities. Governments can use certain basic techniques to minimize deposit and investment market and credit risks. These basic techniques include diversifying the investment portfolio, obtaining collateral on uninsured bank deposits, and having independent third-party safekeeping of investment and collateral securities. The Statement 3 disclosures are designed to provide users with information about the extent to which individual governments use such basic techniques.

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<sup>1</sup>Further references to the Codification are abbreviated. For example, Section 100, paragraph .179, would be Cod. Sec. 100.179.

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The Statement 3 disclosures are particularly concerned with informing financial statement users about the potential for losses associated with the custody of a government's deposits and investment securities. (See question 3.) This is because of the nature of the governmental losses in repurchase agreements and the continuing decline of many financial institutions at the time the Statement was written.

Governments also can use more sophisticated techniques to minimize deposit and investment market and credit risks, such as using only highly capitalized and highly rated financial institutions for deposits of public funds. However, Statement 3 does not require disclosure about whether these more sophisticated techniques are used instead of or in addition to the basic techniques. Therefore, governments and the users of their financial statements should view Statement 3 disclosures as a "starting point" for understanding how governments can and do protect public funds.

### Concept of the Credit Risk Categories

3. Q—Paragraphs 67 and 68 of Statement 3 require deposits and investments to be classified in three "categories of credit risk." What is the purpose of this classification?

A—The purpose of this classification is to inform financial statement users about the extent to which a government's deposits and investments are exposed to custodial credit risk. For purposes of applying Statement 3, custodial credit risk is the risk that a government will not be able (a) to recover deposits if the depository financial institution fails or (b) to recover the value of investment or collateral securities that are in the possession of an outside party if the counterparty to the investment or deposit transaction fails. (See question 24 for a discussion of "counterparty.") Classification in category 1 indicates that the exposure of deposits or investments to potential custodial credit risk is low. The level of potential custodial credit risk is higher for deposits and investments classified in category 2, and highest for those in category 3. (However, as discussed in question 5, the categories are not broad representations that the deposits and investments are "safe" or "unsafe.")

4. Q—How are deposits and investments classified in each of the three categories of credit risk required by paragraphs 67 and 68 of Statement 3?

A—*Deposits:* Deposits with financial institutions are classified depending on whether they are insured or collateralized.

- *Insured deposits:* If deposits with financial institutions are insured, for example by the Federal Deposit Insurance Corporation (FDIC), the potential for loss of those funds is minimized. Deposits that are covered by insurance are classified in category 1. (Further discussion relating to deposit insurance starts at question 65.) Deposits in excess of insurance are classified in one of the three categories depending on conditions concerning the pledging of collateral.
- *Uninsured, uncollateralized deposits:* If the financial institution has not pledged collateral to protect uninsured deposits, the government could suffer a loss of those funds if the financial institution fails. These deposits are classified in category 3.
- *Uninsured, collateralized deposits:* If deposits with financial institutions exceed insurance levels but the financial institution has pledged collateral to protect that uninsured balance, the potential for avoiding losses depends on the government's ability to assert its rights to the collateral securities. Therefore, these deposits are classified in one of the three categories based on *who* holds the collateral securities and *how* they are held, as explained below.

*Investments Other Than Securities:* Investments that are not securities are not classified in categories of credit risk. (See question 22 for a definition of the term *securities* and a discussion of why investments that are not securities are not classified in categories of credit risk.) However, investments that are not securities are subject to all other Statement 3 disclosures, for example, the disclosure of market value as required by paragraph 68 of Statement 3.

## [Completely Superseded]

*Collateral and Investment Securities:* Some securities are exposed to very little or no custodial credit risk. When collateral and investment securities meet one of the following conditions, the deposits and investments are classified in category 1:

- Investment securities protected by the Securities Investor Protection Corporation (SIPC) or by other brokerage insurance. (See questions 96–100.)
- Investment securities registered in the government’s name, provided they have not been endorsed.
- Collateral and investment securities in the possession of the government.

If investment securities are not insured or registered or if collateral or investment securities are not in the possession of the government, the deposits and investments are classified in the three categories based on two conditions concerning the custody of the securities. The first condition is who the securities custodian is and concerns the extent of segregation between the pledging, sale, or acquisition of securities and their custody. (Questions 24–40 discuss this condition.) The second condition concerns how the custodian holds the securities—whether they are held “in the government’s name.” Holding in the government’s name means that the custodial systems and records indicate the government’s rights in the securities. (Questions 41–52 discuss this condition.)

The combinations of these two conditions result in classification in Statement 3 categories as follows:

Category 1: The custodian is the government’s agent and is *not* the counterparty or the counterparty financial institution’s trust department. The custodian holds the securities in the government’s name.

Category 2: The custodian is the counterparty financial institution’s trust department or the counterparty’s agent *and* the custodian holds the securities in the government’s name.

Category 3: The custodian is the counterparty, regardless of whether it holds the securities in the government’s name.

OR

The custodian is the counterparty financial institution’s trust department or the counterparty’s agent *and* the custodian does *not* hold the securities in the government’s name.

Appendix 1 contains two series of questions that may be helpful in classifying many transactions in accordance with the requirements of Statement 3.

### **The Meaning of the Categories: Are Deposits and Investments Safe or Unsafe?**

5. Q—Does classification of deposits and investments in category 1 mean that they are safe, and classification in category 3 mean that they are unsafe?

A—The categories in which deposits and investments are disclosed are *not* broad representations that those amounts are either safe or unsafe from all types of credit risk. Many variables must be considered in assessing whether a particular deposit or investment transaction is “safe” from credit risk. However, the categories can and do provide important information about the relative potential for losses to result from *custodial credit risk*.

As an example of the credit risk information that the three categories do and do not provide, consider an investment in commercial paper (bearer securities) in the possession of the government’s agent and being held in the government’s name. That investment is classified in category 1. This category 1 classification does not reveal the potential for the issuer of those securities to default, or the potential for those securities to be lost or stolen while in the possession of the custodian. However, the category 1

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classification does reveal that, should the broker or dealer of the commercial paper fail, that failure is not expected to affect the government's ability to assert its rights as owner of the commercial paper.

Consider also those governments that suffered losses from repurchase agreements when the seller-borrowers (counterparties) to the repurchase agreements went bankrupt. In these cases, a category 3 situation existed. The governments involved generally had incomplete documentation of individual transactions or the seller-borrowers involved used improper securities segregation procedures. Because the governments did not take possession of the underlying securities through their custodial agents, they had difficulty establishing that they either owned securities or had perfected a security interest in them. Other governments had their agents take possession of the securities underlying their repurchase agreements with these firms—a category 1 situation—and were able to establish their rights in the securities and to fully recover their investments through the value of the securities.

However, to automatically consider that all repurchase agreements classified in category 3 are as “unsafe” as those described above would not be a fair evaluation, because those losses were incurred *when the repurchase agreement counterparty went bankrupt and improper procedures were revealed*. The financial condition of a counterparty and whether proper procedures are used—important elements in assessing risk—are not considered in the Statement 3 credit risk categories.

### Scope of Statement 3

6. Q—Statement 3 applies to “investments” and “deposits with financial institutions,” but does not define those terms. Governments classify different balances as cash and investments on their balance sheets and these differences cause some confusion about what is subject to Statement 3 disclosures. What are “investments” and “deposits” for purposes of Statement 3 disclosures?

A—To apply Statement 3, a preparer needs both to identify investments and deposits and to distinguish between the two. Although Statement 3 does not specifically define the two terms, the extensive discussion in the Statement's Introduction and Background section allows preparers to understand the nature of the items for which disclosure should be made. Although the following discusses the nature of an investment for purposes of Statement 3 disclosures, for some items preparers may need to exercise judgment.

An *investment* can be defined as securities and other assets acquired primarily for the purpose of obtaining income or profit. Therefore, a government's purpose for acquiring a particular asset often is important to identifying it as an investment. For example, a public employee retirement system (PERS) may hold real estate for purposes of appreciation or income—and thus it is an investment. On the other hand, a local government may own buildings to provide low-income housing, which would not be considered an investment for purposes of applying Statement 3.

Some assets may produce income or profit but are not the types of assets for which the Board intended Statement 3 disclosures. For example, interest-bearing tax receivables produce income but are not subject to Statement 3 disclosure. In addition, enterprise fund fixed assets produce income or profit if user charges exceed the cost of those assets. However, the Board did not intend that Statement 3 would apply to those types of assets.

Governments often earn interest on deposits with financial institutions. However, interest-bearing deposits should be treated as deposits, not as investments, in applying Statement 3. *Deposits with financial institutions* are deposit accounts in banks, savings and loan associations, and credit unions. They are demand, savings, and time accounts, including negotiable order of withdrawal (NOW) accounts and nonnegotiable certificates of deposit (CDs). (See also question 90, which discusses how and why *negotiable* CDs, commercial paper-type securities, are considered an investment rather than a deposit for purposes of applying Statement 3.)

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Finally, what constitutes “investments” for a particular government may be identified in the law. Often, these investment laws list both deposits and investments. Occasionally, they also include items that are not consistent with the types of items for which Statement 3 disclosure is appropriate. For example, state law may authorize a state department or authority to “invest” monies by making low-interest loans to students. Despite their interest-bearing feature, these student and other program loans are interest-bearing receivables and not intended to be subject to Statement 3 disclosures.

7. Q—Sometimes the following transactions are presented in Statement 3 disclosures: deposits with the U.S. Treasury for unemployment compensation, food stamps, interfund loans, and equity in joint ventures. Are these transactions subject to Statement 3 disclosures?

A—No. These transactions are not “deposits with financial institutions” and generally are not considered “investments.” To subject them to Statement 3 disclosures would not serve the purpose of the Statement, which, as discussed in question 2, is to provide financial statement users with information about deposit and investment market and credit risk.

8. Q—Are private placements, such as for venture capital and limited partnerships, “investments” for purposes of Statement 3?

A—Yes, these should be considered investments subject to Statement 3 disclosures. Although private placements may serve a governmental purpose as well as provide investment income or profit, the transactions are generally accepted as “investments.” (See also question 22. Although private placements are investments for purposes of Statement 3 disclosures, they *are not* “securities” for purposes of credit risk classification.)

A distinction should be made between venture capital and joint ventures with private-sector entities. This distinction is important because investments in joint ventures are not considered subject to Statement 3 disclosures (see question 7) and venture capital investments are. According to Cod. Sec. J50.101, “Joint Ventures,” a joint venture is an activity conducted for the benefit of the public or service recipients. (GASB Statement No. 14, *The Financial Reporting Entity*, provides an expanded definition of a joint venture [paragraph 69] and moves that definition to Cod. Sec. J50.102.) The purpose of a venture capital investment is to support the development of a specific organization. When a government provides venture capital, it may do so to earn a high investment yield, to encourage economic development in a specific industry or region, or, for example, to encourage the minority ownership of business.

9. Q—Does Statement 3 apply to all of a government’s deposits and investments?

A—Except for changes resulting from Statement 14 as discussed below and in question 116, Statement 3 applies to all deposits with financial institutions and investments that are reported on the face of a governmental reporting entity’s financial statements. Therefore, the Statement applies to deposit and investment transactions of all fund types, including those for which the reporting entity is a custodian and that are reported in an agency, trust, or other fund—such as deferred compensation plan assets and pooled amounts invested by a state treasurer on behalf of local governments. (See also question 108 concerning Internal Revenue Code [IRC] Section 457 deferred compensation plan assets.)

Many of the deposits and investments that are subject to Statement 3 disclosures may be reported on the balance sheet using different titles. For example, some deposits and investments may be reported on the balance sheet as “cash and cash equivalents.” (See question 58.) Others may be reported on the balance sheet in titles that do not identify their nature as deposits and investments. For example, securities held as escheats or other unclaimed property may be reported in an agency fund balance sheet without specific identification of the nature of the item. Despite the balance sheet presentation, these securities are subject to the Statement 3 disclosures for investments.

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Sometimes questions arise whether annuity contracts that are in the name of lottery prize winners are subject to Statement 3 disclosures. If they are reported in the government's financial statements, they are subject to Statement 3 disclosures. Further, Statement 3 applies to deposits and investments held by another entity for a government—for example, amounts held by fiscal agents for bond payments and reserves—if they are reported on the face of the government's financial statements.

Statement 3 also applies to deposits and investments of component units included in a reporting entity's financial statements, although the manner in which it is applied will change as a result of GASB Statement 14, as discussed in question 116. Specifically, Statement 14 requires that disclosures for discretely presented component units be made separately from disclosures for the primary government and its blended component units. It also may result in not presenting Statement 3 disclosures for some discretely presented component units.

Statement 3 does not apply to “off-balance sheet” deposits and investments, for example, amounts held by escrow agents on debt that is reported as defeased in substance in accordance with Cod. Sec. D20, “Debt Extinguishments.”

10. *Q*—Does Statement 3 apply to the separately issued financial statements of a governmental college or university, or does it only apply if and when a component unit college or university is included in the financial statements of another governmental reporting entity? What about governmental utilities and healthcare providers?

*A*—Statement 3 applies to all state and local governmental entities, including special-purpose governmental entities such as utilities, healthcare providers, colleges, and universities. If financial statements for such an entity are presented in accordance with generally accepted accounting principles (GAAP), Statement 3 disclosures apply, regardless of whether the entity is a component unit of another governmental reporting entity, and regardless of whether the entity issues separate reports or is included in a reporting entity's financial statements. (Throughout this Implementation Guide, the term government is used to refer to all governmental entities, including special-purpose governmental entities.)

### Overall Presentation of the Statement 3 Disclosures

11. *Q*—Should the Statement 3 disclosures provide information by fund or fund type, or merely in the aggregate?

*A*—The GASB concluded that the Statement 3 disclosures should be made in the aggregate to reduce the disclosures to those considered necessary. However, paragraph 64 of Statement 3 does not preclude *additional or separate* presentation by fund or fund type, and many governments design their Statement 3 disclosures to report separately on certain funds (such as pension trust funds) or component units. (See question 116 for changes resulting from the application of Statement 14, concerning component units.)

In addition, paragraphs 65, 70, and 71 of Statement 3 require additional or separate disclosures by fund or fund type in certain circumstances if the aggregated presentation is potentially misleading or obscures information. These areas of additional or separate disclosures concern the types of investments authorized (see question 16), credit risk categories, and unrealized investment losses.

12. *Q*—Are all Statement 3 disclosures required to be made in a single note?

*A*—No. As discussed in question 11, Statement 3 does not preclude separate or additional presentations by fund or fund type. However, if a separate presentation is made for a separate investment area, such as a pension trust fund, a cross-reference between the primary Statement 3

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disclosure and the separate pension trust fund disclosure could help the financial statement users better understand the Statement 3 disclosure in relation to the cash and investments presented in the balance sheet.

Paragraph 65 of Statement 3 requires disclosure of the types of investments authorized by legal or contractual provisions. Some governments present this information in the summary of significant accounting policies (SSAP) separately from the note that presents the other Statement 3-required disclosures about deposits and investments. If this is done, references between the deposit and investment disclosure and the SSAP could be made. These references could help financial statement users find all information appropriate to their evaluation of investment risk.

### Legal Provisions

13. Q—Paragraphs 65 and 66 of Statement 3 require disclosures about the legal and contractual provisions that govern a government’s deposits and investments. What are the sources of *legal* provisions for purposes of these disclosures?

A—Footnote 9 of Statement 3 lists various forms of legal provisions, including constitutions, ordinances, and governing body orders. Legal provisions are those requirements that carry the force of law.

Legislation that governs the deposits and investments of a state government or its local political subdivisions usually is in one of three forms. The first form provides a detailed list of permissible deposits and investments (*a legal list*) and other requirements, such as for custody of collateral on deposits and of investment securities. Many state statutes use this form. The second form, commonly used for pension fund and other fiduciary investments, is a *prudent-person* or *prudent-expert* rule. These rules are broad statements of intent, generally requiring investment selection and management to be made with prudent, discreet, and intelligent judgment and care. Additional investment objectives may be given in a prudent-person or prudent-expert rule, for example, to consider safety of principal before investment yield. The third form of state deposit and investment legislation is *home-rule authority*, which allows local governments to enact their own investment legislation. Sometimes local governments are given home-rule authority in some investment areas (such as investment selection) and detailed statutory requirements in others (such as a requirement to have collateral on deposits).

State investment legislation, supplemented by legal requirements established by the governing body or other oversight body of the state or local governmental entity or agency, should be used in applying the requirements of paragraphs 65 and 66. For example, if state statutes provide that the investments of a PERS should be guided by a prudent-person rule and there are no other legal requirements concerning investments for the system, the prudent-person rule should be the basis for the disclosures required by paragraphs 65 and 66. If, however, the system’s board of trustees establishes detailed investment policies and board actions constitute legal requirements, the disclosures should be based on the board’s policies. Similarly, local ordinances enacted by a local government with home-rule authority should be the basis for the disclosures.

Although important to an entity’s portfolio management, investment policies that are not legal requirements are not required to be used as a basis for paragraphs 65 and 66 disclosures. For example, if state law is silent on custodial arrangements for investment securities but it is the policy of the office of the state treasurer to have independent third-party custody, that policy is not a legal provision. Therefore, although violation of that custodial policy should be of concern to management, Statement 3 does not require its disclosure in the notes to financial statements. (See question 114 for a discussion about disclosure of significant violations of legal and contractual provisions.)

## [Completely Superseded]

14. Q—Paragraph 65 of Statement 3 requires disclosure of the types of investments authorized by legal or contractual provisions. How detailed should this disclosure be?

A—The disclosure should be brief but informative. The objective of the disclosure is to give users basic information about the government’s investment environment and its potential risk. (See the nonauthoritative illustrative examples in the appendixes of Statement 3, which is reproduced in this Implementation Guide in Appendix 3.)

The disclosure can include a citation of the legal provisions that list authorized investments, but that should not be the only information provided. On the other hand, users should not be given needless detail. If the list of investment types authorized by legal or contractual provisions is long and detailed, appropriate summary information could be given. For instance, a state law listing permissible investments may be several pages long, including, for example, the specific U.S. agency obligations in which local governments may invest. In this situation, the note disclosure might summarize these authorized investments as “various U.S. agency obligations.”

If legal provisions require only that investments be selected on the basis of a prudent-person or prudent-expert rule, only that information need be disclosed. That is, the government does not need to disclose the types of investments it selects in adherence with the prudent-person rule, unless another legal requirement requires the use of specific investment types.

15. Q—Is disclosure required if an investment type is authorized by legal provisions but is never used because of management policy?

A—Yes, paragraph 65 of Statement 3 requires the government to disclose that the investment type is authorized. One of the objectives of the Statement 3 disclosures is to inform financial statement users about potential future risk. Information about the government’s *ability* to invest in the instrument is important to a user’s evaluation of potential future risk. This is because management policy against using the investment type could be changed in the future without legislative action, thus changing the government’s potential risk.

16. Q—Paragraph 65 of Statement 3 requires additional disclosure about differences in the types of investments authorized for different funds, fund types, or component units. When is this disclosure required?

A—Whether this disclosure is needed in particular situations is a matter of judgment, but paragraph 65 establishes guidance for when *minimal* additional disclosure is required. Disclosure of the differences in authorized investment types is required if (a) the types authorized for different funds, fund types, or component units differ *significantly* from those authorized for the primary government and (b) the investment activity of the fund, fund type, or component unit is *material* in comparison to the activity of the *combined entity’s* investment activity. An investment type is significantly different if its form differs significantly from those of other investments (as discussed in question 17). Taken together, conditions (a) and (b) minimize the situations in which additional disclosures should be made.

For example, suppose that a government is authorized to invest the monies of both the pension trust fund and the general fund in U.S. government securities, and that it also may invest the monies of the pension trust fund in corporate equity securities. Equity securities are a significantly different form of investment from U.S. government securities. If the investment activity of the pension trust fund is material in comparison to the investment activity of the combined entity, Statement 3 requires a statement that the pension fund is additionally authorized to invest in corporate equity securities. A separate list of all of the pension fund’s authorized investment types is not needed.

## Investment Types

17. Q—Paragraphs 65, 68, and 74 of Statement 3 require certain disclosures based on “types of investments.” What is an “investment type”?

A—Although Statement 3 does not define *investment type*, it does provide some guidance in the nonauthoritative illustrative examples in the appendixes, which are reproduced in this Implementation Guide in Appendix 3. Those illustrative examples show repurchase agreements, U.S. government securities, bankers’ acceptances, commercial paper, and corporate bonds as different investment types. Investments are of different types when they take different forms.

Different investment risks are basic features that give one investment a different form from another. Investment risks include market and issuer credit risks. Market risk is the risk that the value of an investment will decline. Equity investments pose a different market risk than do short-term fixed-income investments. Issuer credit risk includes the risk that the issuer of a security will not redeem it. For example, there is a difference in issuer credit risk between U.S. Treasury securities and corporate securities.

Investment risks also include liquidity risk, currency risk, and political or sovereign risk. Liquidity risk is the risk that an investment cannot quickly be converted to cash without a loss of some principal. Real estate usually carries different liquidity risk than does an investment in an open-end mutual fund. Currency risk, which is posed by those investments that are denominated in other than the U.S. dollar, is the risk that the exchange value of the other currency will decline in relation to the U.S. dollar. Finally, political or sovereign risk, associated with investments in foreign issues, includes the risk that foreign assets might be expropriated.

Ultimately, determining the “investment types” to be disclosed in a government’s financial statements is a decision best made by the financial statement preparers, perhaps together with the investment officers, based on how the government’s portfolio is structured in terms of different investment forms and risks.

18. Q—Are “cash equivalents” an investment type?

A—“Cash equivalents” should not be considered an “investment type” for Statement 3 purposes. Although both three-month commercial paper and three-month U.S. Treasury bills meet the definition of cash equivalents in Cod. Sec. 2450.106 (“Cash Flow Statements”), significant differences in the forms of the two investments make it necessary to present them as separate investment types in the Statement 3 disclosure.

19. Q—For purposes of applying paragraph 68 of Statement 3, can different investment portfolios be disclosed by a government as separate “investment types”? That is, can the disclosure simply present “deferred compensation plan assets” and “retirement plan assets”? If not, how should they be disclosed?

A—Different investment portfolios do not constitute “investment types.” Financial statement users could discern only limited information about the market or issuer credit risk in the pension plan’s portfolio if those investments are reported in the Statement 3 disclosure simply as “pension plan assets.” Instead, the government should group the different investments within the portfolio into types as explained in question 17, for example, U.S. Treasury obligations, corporate stock, and commercial paper. Statement 3 provides an illustrative note for a government that includes a pension trust fund (in Appendix 3 of this guide).

## [Completely Superseded]

20. Q—For purposes of presenting investments by type as required by paragraph 68 of Statement 3, some governments show sizable portions of their portfolios as “Other.” Is this appropriate?

A—It is not appropriate to present material amounts of a government’s portfolio in this way, unless the narrative of the note disclosure describes the composition of the “Other” or “Miscellaneous” category.

21. Q—Sometimes it is not readily apparent what a government’s different investment types are by the labels that are presented in the note disclosure. For example, an investment in an investment fund that purchases companies through leveraged buyouts may be presented in the note disclosures as “leveraged buyouts.” If this is the case, is the government required to provide some explanation about those investment types?

A—If a term is not well understood in common usage or users in general would not understand the nature of a particular investment type by the label it has been given, preparers could either provide a brief description or use a term that would be understood.

### Applying the Credit Risk Categories

#### Definition of Securities

22. Q—Uninsured deposits and investments are classified in the three categories of credit risk based on the custody of collateral and investment securities. What are *securities*? Do governments have investments that are not securities?

A—A security is a transferable financial instrument that evidences ownership or creditorship. Securities that often are held by or pledged to state and local governments include U.S. Treasury bills, notes, and bonds; federal agency and instrumentality obligations, including asset-backed securities; corporate debt instruments, including commercial paper; corporate equity instruments; negotiable CDs; bankers’ acceptances; shares of closed-end mutual funds; and shares of unit investment trusts. Securities are in both paper and book entry form. (See questions 43–46.) The concept of the Statement 3 categories is to provide information about a government’s exposure to custodial credit risk. Therefore, “securities” includes those instruments that could expose a government to a potential for loss if another party has custody of them.

“Securities” does not encompass investments without a transferable financial instrument that evidences ownership or creditorship. Thus, “securities” does not include investments made directly with another party (for example, limited partnerships), real estate, or direct investments in mortgages and other loans. Investments in open-end mutual funds, pools managed by other governments, annuity contracts, and guaranteed investment contracts also are not considered securities for purposes of credit risk classification as discussed in questions 102, 104, 108, and 110, respectively.

Investments that are not “securities” are not classified in the three categories of credit risk. This treatment is provided for by the language of paragraph 68 of Statement 3 (which calls for classification based on who holds the securities and how they are held) and by paragraph 69 (which provides that certain investments are not classified because they are not evidenced by securities). However, this exemption from classification does not mean that such investments are without credit risk. Instead, it means that they are not securities that are subject to *custodial credit risk*. (As discussed in question 4, although not “securities,” all such investments are subject to Statement 3 disclosures other than credit risk classification. Presentation of these investments in the Statement 3 note disclosure is discussed in question 56.)

## Definition of Insurance

23. Q—Question 4 indicates that deposits and investments are classified in category 1 if they are insured, for example, by FDIC insurance or SIPC protection. What if collateral or investment securities are insured by the issuer, such as U.S. Treasury securities that are backed by the full faith and credit of the government? Would these deposits and investments also be classified in category 1 as “insured”?

A—No, deposits and investments are not classified in category 1 as “insured” as a result of issuer guarantees. Guarantees by the U.S. government on its obligations relate to its own payment performance, not to the performance of a custodian of those securities. “Insurance” for purposes of category 1 classification of deposits and investments relates only to guarantees on the performance of the custodian.

## Custody of Securities

### *Who the Securities Custodian Is*

**Note:** Proper classification of deposits and investment securities depends on both who the securities custodian is and how the securities are held. This section on who the securities custodian is should be read together with the section on how the securities are held, starting at question 41.

### Counterparty

24. Q—To classify deposits and investments in the three credit risk categories, the preparer may have to determine whether the securities custodian is related to the counterparty in the transaction. Who or what is a counterparty for purposes of Statement 3 credit risk classification?

A—For purposes of Statement 3 credit risk classification, a counterparty is the party that pledges collateral or repurchase agreement securities to the government, or that sells investments to or buys them for the government. For collateral on deposits in financial institutions, the pledging financial institution is a counterparty. For brokerage accounts, the broker or dealer is a counterparty. For repurchase agreements, the seller-borrower in the repurchase agreement is a counterparty. More than one party can be a counterparty in a single transaction for purposes of Statement 3. For example, the counterparties in a repurchase agreement can include both the seller-borrower and the broker-dealer or financial institution that acquires the repurchase agreement for the government.

Usually, investment securities are purchased in the securities markets, for example, the Over-the-Counter (OTC) market and the stock markets. In these transactions, governments and perhaps even their brokers will not know the party that previously owned the securities. Although that selling party technically is a counterparty, the operations of these markets effectively eliminate that party’s identity and thereby its rights to the securities. Instead, the important counterparty for purposes of credit risk classification of investments that are acquired in securities market transactions is the acquiring broker-dealer.

However, if investment securities are acquired outside of the securities markets—for example, through a direct or private purchase—identifying the party that previously owned them is important to proper classification. This is because the previous owner may be able to retain access and rights to the securities. To properly classify the investment in this situation, the preparer must evaluate whether the custodian is either the previous owner of the securities or the trust department or agent of the previous owner. In these transactions, either the government’s investment officers or the acquiring broker-dealer will know who previously owned the securities.

## [Completely Superseded]

25. Q—Question 4 indicates that custody by the counterparty is classified in category 3. What if the counterparty is under contract to serve as the government’s custodial agent? Why would the deposit or investment not be classified in category 1 as “held by the government’s agent”?

A—If the counterparty has custody, the situation is *always* classified in category 3. This situation was discussed in question 1 of GASB Technical Bulletin (TB) No. 87-1, *Applying Paragraph 68 of GASB Statement 3* (reproduced in Appendix 3 of this guide). As discussed in question 29 of this guide, the term agent as used in paragraphs 67 and 68 of Statement 3 refers to a financial institution or broker-dealer that is a custodial agent *only*. If a financial institution or broker-dealer is both the government’s counterparty and the custodial agent in the transaction, its identity as the counterparty takes precedence in classifying deposits and investments in credit risk categories.

26. Q—Suppose the government’s custodial agent was the broker for some investments, but other investments were acquired through a different brokerage firm. Are all the investments for which that custodian is holding the securities classified in category 3 because the custodian is identified as a counterparty for some of the transactions?

A—No. Only those investments for which the securities custodian is the counterparty are classified in category 3. The investments that were acquired through a different brokerage firm should be classified in category 1.

27. Q—Usually, a government’s custodial agent settles an investment transaction by paying for the securities when they are delivered. Does being involved in settlement mean that the custodial agent is buying the securities for the government and is thus a counterparty?

A—No. Being involved in the settlement function *does not* confer counterparty status on a party that otherwise is the government’s custodial agent only. “Buying securities for the government” means placing the order for the securities, not simply paying for them. Settlement is a normal function for a securities custodian.

28. Q—How does a government’s use of an investment adviser or manager affect the classification of its investments? Is an investment adviser or manager a counterparty?

A—An investment *adviser* may or may not be a counterparty. If an adviser’s only function in the acquisition of investments is to advise on which types of investments or which particular investments to acquire, the adviser is not a counterparty for purposes of credit risk classification. On the other hand, if the adviser acquires those investments for the government, whether working as a broker or through a broker, the adviser is a counterparty.

An investment *manager* is responsible for managing a portfolio, including acquiring investments. An investment manager is a counterparty because of the acquisition function.

### Agent

29. Q—The credit risk categories in paragraphs 67 and 68 of Statement 3 use the term *agent*, for example, *government’s agent* and *counterparty’s agent*. What does Statement 3 mean by its use of the term *agent*?

A—Statement 3 uses the term *agent* as it is generally understood in a legal sense—a person or firm empowered to act for another. An agent is the substitute or representative of its principal and derives its authority from the principal. However, for purposes of classifying deposits and investments, the term *agent* as used in paragraphs 67 and 68 is meant within a narrow area of responsibility—that of *custodial agent only*.

## [Completely Superseded]

This was an issue raised in implementing Statement 3 and therefore was addressed in question 1 of GASB TB 87-1 (in Appendix 3 of this guide). For deposits and investments to be classified in category 1 because securities are “held by the government’s agent,” the custodian has to be contractually obligated to the government to hold the securities at the government’s discretion. If the securities custodian is the counterparty’s agent in that transaction (and is not also the government’s agent), the deposits and investments are classified in either category 2 or 3, depending on how they are held. (See also question 25 for a discussion of classification when the counterparty is the custodial agent.)

30. Q—What makes a custodian an agent of the government? Does the government have to select the custodian? Is a written contract needed?

A—A securities custodian is the government’s agent if it acts as the representative of the government to protect the government’s rights in the securities. In evaluating whether the custodian is the government’s agent, the preparer should examine the conditions under which the custodian will release the securities. Factors of (a) who selects the custodian and (b) written evidence of the agency relationship may provide additional evidence of an agency relationship.

*Releasing Securities:* The function of a custodial agent is to hold and release securities. To determine whether the custodian is the government’s agent, one must determine whether the custodian acts at the direction of the government in holding and releasing securities. The more important of these two functions is the release of securities because improper release can expose the government to risk of loss.

A custodian that is the government’s agent will release the government’s investment securities to the government or to someone else at the government’s direction without having to obtain approval from anyone else. Further, the government’s custodial agent will not release the securities to someone other than the government without the government’s approval. A custodian that releases securities owned by the government at someone else’s direction and without the government’s approval is not acting as the government’s agent.

The conditions for release of collateral or repurchase agreement securities pledged to the government differ from the conditions for release of securities owned by the government. This difference is because both the pledgee government and the pledgor counterparty have rights in the securities. A custodian that is the government’s agent will not release the securities to the pledgor counterparty or to someone else at the pledgor’s direction unless the government (a) approves, (b) informs the custodian it has completed its transaction with the pledgor counterparty, or (c) commits an act of default. Because of the pledgor counterparty’s rights in the securities, however, a custodian that is the government’s agent probably also will not release the securities to the government or to someone else at the government’s direction unless the pledgor counterparty also (a) approves or (b) commits an act of default. This requirement for the custodian also to protect the rights of the pledgor counterparty does not necessarily diminish the fact that the custodian is the government’s agent. (See further discussion of three-party custodial arrangements in questions 85 and 109.) If a custodian will release collateral or repurchase agreement securities to the pledgor counterparty without the approval of the government, the custodian is not acting as the government’s agent, even if the government subsequently is informed of the release.

Often, a collateral pledge agreement or repurchase agreement permits the pledgor to substitute securities of equal or greater value with the custodian without the specific approval of the pledgee government. Such a situation would not change the fact that the custodian is the government’s agent because the collateral pledge or repurchase agreement constitutes the government’s prior approval for the release of the securities. However, if the custodian permits substitution by the pledgor counterparty in the absence of the government’s current or prior approval, evidence that the custodian is the government’s agent would be diminished or eliminated.

## [Completely Superseded]

*Selection of Custodian:* The government's selection of the custodian would provide additional evidence that the custodian is the government's agent. However, a custodian that is not selected by the government may still be the government's agent. For example, the custodian for a tri-party repurchase agreement program usually is selected by the repurchase agreement counterparty. However, the tri-party custodial agreement establishes the custodian as agent both of the government and of the repurchase agreement counterparty. On the other hand, the government's selection of the custodian does not automatically establish an agency relationship between the custodian and the government. That is, the custodian still has to represent the government in the custody transaction.

*Written Evidence:* In many cases, an agency relationship between a government and a custodian is established in writing. Sometimes, this writing is a contract. In other cases, legal provisions serve as written evidence of the nature and scope of the custodian's responsibilities. For example, the statutes that require deposits with financial institutions to be collateralized often provide for the types of entities that may hold the collateral and the responsibilities the custodian has to protect the government's interests in the collateral.

The absence of writing does not mean the custodian cannot be the government's agent. However, the preparer would need to more closely evaluate the actual relationship between the government and the custodian to determine whether an agency relationship exists. That is, in the absence of writing, the matters of how the custodian's operations protect the government's interests and who selects the custodian become more important in establishing that the custodian is the government's agent.

31. Q—Is a legal opinion needed to determine whether a custodian is the government's agent?

A—Although agency is a matter of law, preparers generally have not found it necessary to obtain a legal opinion to determine whether the custodian is the government's agent. This is because custodial arrangements usually are clear concerning whether the custodian is acting as the government's agent. However, if the factors discussed in question 30 have been considered and questions continue about which party the custodian is representing, the preparer could consult with the government's legal counsel.

### **Special issues concerning trust departments and bank holding companies**

32. Q—Question 4 states that if securities are in the custody of the counterparty financial institution's trust department, the deposits and investments are classified in either category 2 or category 3. Assets held by trust departments as custodial agents for outside parties are considered legally separate from the assets of the financial institution. Why did the GASB not recognize that legal separation and allow category 1 presentation if the counterparty's trust department is the government's agent?

A—Research and responses to the Exposure Draft of Statement 3 led the GASB to conclude that the relationship between a financial institution and its own trust department is different from the relationship between a financial institution and a third party. Specifically, the GASB observed that the financial institution and its trust department share common management. Therefore, despite laws and regulations that require separation of assets, it was the GASB's position that the independence of those trust departments and the separation of assets was, in some situations, not sufficiently certain as to permit a conclusion of independence in all cases.

However, the GASB did recognize that the fiduciary responsibilities required of a trust department tend to provide a greater measure of protection from custodial credit risk than does custody by the financial institution itself. Therefore, provided that the trust department of the counterparty financial institution is holding the securities in the government's name, the deposits and investments are classified in category 2. Category 2 communicates less potential custodial credit risk than does category 3, which is

## [Completely Superseded]

how the deposits and investments would be classified if the securities are held by the counterparty financial institution.

33. Q—Is a financial institution’s safekeeping department the same as a trust department?

A—No. This issue was addressed in GASB TB 87-1, paragraph 5 (in Appendix 3 of this guide). A financial institution provides safekeeping services as a normal business function. A trust department is a separate fiduciary function authorized by and regulated under various state and federal laws. Safekeeping departments are not considered trust departments for the purpose of classifying deposits and investments in categories of credit risk. Custody by a safekeeping department should be evaluated as custody by a financial institution rather than as custody by a trust department.

34. Q—Can nonfinancial institution broker-dealers have trust departments?

A—No, there are no legal provisions for such broker-dealers to have trust departments.

35. Q—How are investments classified if they are both acquired through and held in custody by a trust department?

A—The investments would be classified in category 3 because they are held by the counterparty. In this situation, there is no segregation between the acquisition and custody functions. As discussed in question 25, custody by the counterparty *always* is classified in category 3, regardless of other relationships.

36. Q—Often governments use trust departments as trust or fiscal agents, for example, to hold bond reserves or amounts that shortly will be used to pay debt principal and interest. In these situations, the trust department both acquires and holds investments under the provisions of a trust agreement that details the trust department’s fiduciary responsibilities. How are these “amounts held in trust” classified?

A—Statement 3 requires investments to be classified in category 3 if the counterparty is the custodian (see questions 25 and 35), but does not address the particular situation of trust agreements. In November 1991, the GASB adopted a project to consider how such trust accounts should be reported for purposes of Statement 3 disclosures. The project will consider whether trust accounts should be classified in other than category 3 and, if they are, identify the features that a trust account must have to warrant that reporting.

37. Q—What is a bank holding company? How are deposits and investments classified when the counterparty and the custodial agent are affiliates of the same bank holding company? Specifically, are the two affiliate banks treated as independent parties, or are they treated as related parties?

A—A bank holding company is a company that controls one or more banks and also may own subsidiaries with operations closely related to banking. Bank holding companies provide for common ownership of several banks; they permitted banking systems to develop when law severely limited branch banking. Generally, the Bank Holding Company Act provides that a holding company has control over a bank if it directly or indirectly owns, controls, or holds with power to vote 25 percent or more of the voting stock of a bank. Almost all large banks and many smaller banks in the United States are owned by holding companies.

Statement 3 does not address whether affiliate banks and other subsidiaries of a common bank holding company are independent or related parties, an issue that is central to the credit risk categories. However, GASB staff has taken the position that affiliates of a common bank holding company should not be viewed as independent parties. The commonality of management among affiliates presents the possibility for one party to influence or affect the operations of another. If one affiliate bank pledges collateral to a government on its deposit account, and another affiliate bank has custody of the collateral

## [Completely Superseded]

and is holding it as the government's agent and in the government's name, the deposits would be classified in category 3. This is because affiliates of a bank holding company are viewed to be in substance the same party. (See question 38 regarding custody by an affiliate's trust department.)

Some believe that affiliates should be treated as independent parties because the banks are legally separate corporations. This position would result in a category 1 classification for the deposits described in the example in the preceding paragraph. Those who take this position cite the GASB's recognition that trust departments have legal standing separate from their financial institutions. Others with this position would classify the deposits in category 2—in the same manner the deposits would be classified if the counterparty's trust department were the custodian of the collateral securities. However, as explained in paragraphs 99 and 100 of the Basis for Conclusions of Statement 3, the GASB's decision for separate presentation of trust department custody was based on the presence of fiduciary law and regulation, not on separation under corporate law.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) recognizes a relationship between affiliate banks, despite their separate legal form. FIRREA states that any insured depository institution is liable for any loss incurred or expected to be incurred by the FDIC in connection with the default of or assistance provided to a commonly controlled institution. FIRREA defines common control in this situation as including institutions controlled by the same holding company.

38. Q—How would a deposit be classified if collateral is pledged by one affiliate of a bank holding company and it is held in the trust department of another affiliate bank in the government's name?

A—The deposit would be classified in category 2. The custodial trust department would be viewed as the counterparty's trust department.

39. Q—Are deposits and investments always classified in category 2 or category 3 whenever the collateral or unregistered investment securities are in the custody of a trust department?

A—No. Deposits and investments are classified in category 1 if the trust department holding the securities is not part of or affiliated with the counterparty financial institution and if that trust department is the government's agent and is holding the securities in the government's name. Deposits and investments are classified in category 2 or category 3 only if the custodial trust department has a relationship with the counterparty because it is (a) the counterparty, (b) part of the counterparty financial institution, (c) affiliated with the counterparty financial institution, or (d) the counterparty's agent and is not also the government's agent.

40. Q—If the government's custodial agent is a financial institution, does custody have to be within the trust department for the deposits and investments to be classified in category 1? Or, instead, can custody by the safekeeping department be classified in category 1?

A—Provided that the financial institution is the government's agent and is not the counterparty or an affiliate of the counterparty, deposits and investments are classified in category 1, regardless of the department that provides the custodial services.

### ***How the Securities Are Held***

**Note:** Proper classification of deposits and investment securities depends on both who the securities custodian is and how the securities are held. This section on how the securities are held should be read together with the section on who the securities custodian is, starting at question 24.

## [Completely Superseded]

41. Q—Question 4 states that the second condition that affects how deposits and investments are classified in credit risk categories concerns whether the securities are held in the government’s name. Does this mean securities must be registered in the government’s name to meet the criterion of “held in the government’s name”?

A—No. Holding in the government’s name means that the custodial systems and records indicate the government’s rights in the securities. The way in which securities are “held in the government’s name” differs between investment securities and collateral and repurchase agreement securities. There also are differences between paper and book entry securities. Questions 42–52 discuss issues relating to this criterion in different circumstances where the custodian is a party other than the counterparty. (The “held in the name of the government” criterion does not change the category 3 classification if the counterparty is the custodian.)

### **Collateral and repurchase agreement securities versus investment securities**

42. Q—For collateral on deposits with financial institutions and for securities underlying repurchase agreements, do custodial systems and records have to show that the government is the owner of the securities to meet the “held in the name of the government” criterion? If not, what should the custodian’s systems and records show? Are there differences in how the criterion is applied to collateral and repurchase agreement securities compared with investment securities?

A—If securities are pledged to a government, whether to secure deposits or to secure repurchase agreements, the custodian’s records and its system of holding the securities would not show that the government is the owner. The pledgor is the owner. The records and systems would, however, have to show that the government is the pledgee to meet the “held in the name of the government” criterion.

The custodial systems and records needed to meet this criterion for *investment* securities are somewhat different. The government is the owner of these securities and, to meet the “held in the name of the government” criterion, the custodian’s records and its system of holding the investment securities have to show that the government, and not the custodian or some other party, is the owner of the securities.

### **Paper securities**

#### ***Registered in the government’s name***

43. Q—Many securities are issued in paper form; that is, a certificate provides evidence of ownership. Sometimes securities certificates are registered in the government’s name. How is the “held in the name of the government” criterion met for securities registered in the government’s name and held by a custodian?

A—If securities are registered in the government’s name and they have not been endorsed, the “held in the name of the government” criterion is not relevant to classification of the investment in categories of credit risk. As explained in question 4, those investments are classified in category 1. If the government has endorsed the registered securities, they should be evaluated as bearer securities or as street or nominee name securities as discussed in questions 44 and 45, respectively.

# [Completely Superseded]

## **Bearer securities**

44. Q—Some paper securities are issued in or endorsed to bearer form; the bearer or holder of the certificate is presumed to be the owner. How is the “held in the name of the government” criterion met for bearer securities owned by the government and held by a custodian? Are the conditions for meeting the criterion different for bearer securities pledged to the government?

A—To meet the “held in the name of the government” criterion for bearer securities owned by the government, two conditions have to exist. First, the custodian must have physical custody of the securities (or, as discussed in question 50, another party must be holding the physical securities in the name of the custodian for the benefit of the custodian’s clients). Second, the custodian’s internal records must identify the government as the owner of the bearer securities. For bearer securities pledged to the government as collateral for deposits or for repurchase agreements, the only difference for meeting the criterion is that the custodian’s internal records must identify the government as the pledgee of the securities.

## **Street name and nominee name registration**

45. Q—Two terms often used in describing how a government’s securities are registered are *street name* and *nominee name*. What does it mean to have securities in street or nominee name? What effect, if any, does the use of street or nominee name registration have on determining whether securities are held in the name of the government?

A—Fundamentally, securities held in street name and nominee name are the same for purposes of Statement 3 classification. Both terms indicate that the securities are issued in or endorsed to the name of a securities depository, broker-dealer, or other financial services company, on behalf of the true beneficial owners of the securities.

The term *nominee name* denotes arrangements used principally by institutional investors and financial agents (such as bank and trust companies) for the registration of securities held by them for their own account or the accounts of customers. In most instances, the nominee is a partnership formed solely for the purpose of acting as record holder of the securities. Perhaps the largest use of nominee name arrangements is by securities depositories on behalf of their participants.

The term *street name* is used by the securities industry to denote securities registered in the name of a brokerage firm or its nominee. Such securities frequently belong to customers of the firm.

Securities are held in street or nominee name to allow the transfer of the beneficial ownership of securities from one party to another without re-registration and with a minimum of physical movement of the paper. The use of street or nominee names for the registration of paper securities does not change the fact that a custodian is “holding in the name of the government.” This is because of the presumption underlying the use of street or nominee name registration that another party may be the true beneficial owner.

Securities in the nominee name of a securities depository are referred to as “book entry” securities. Questions 46–49 discuss how to evaluate book entry systems for purposes of applying the “held in the name of the government” criterion. For securities owned by a government and registered in or endorsed to the street or nominee name of the custodial broker-dealer or other financial agent, the “held in the name of the government” criterion is met if the custodian’s internal records identify the government as the owner of the securities. If the securities are pledged to the government as collateral for deposits or for repurchase agreements, the only difference in meeting the criterion is that the custodian’s internal records should identify the government as the pledgee of the securities.

# [Completely Superseded]

## Book entry securities

46. Q—What is a book entry system for securities? How are securities in book entry systems owned by or pledged to governments?

A—Book entry is a system that eliminates the need for physically moving bearer-form paper or re-registering securities certificates to transfer ownership. There are two types of book entry systems. The first is a system operated by or for the issuer of the securities. An example is the system operated by the Federal Reserve for the securities of the U.S. Treasury and various U.S. government agencies. The securities in the Federal Reserve System are referred to as book entry securities; these securities do not exist in paper form, but only as entries on the automated records of the Federal Reserve System. The second type of book entry system is a securities depository system, such as that operated by the Depository Trust Company. In a depository system, paper securities are held by the depository in bearer form or registered in the depository's nominee name. A depository also may hold securities in the Federal Reserve's book entry system.

A government's access to the securities in these book entry systems generally is through the accounts of members or participants of the system, generally financial institutions and broker-dealers. Governments do not have their own accounts to hold book entry securities except in limited situations involving the Federal Reserve and Treasury systems as described in question 48. (See also question 85 on Federal Reserve pledge accounts.) Members and participants can use separate accounts for securities belonging to their customers. Different systems refer to these customer accounts differently, for example, using the term *custodial* or *fiduciary*. Some depository system participants have opened separate accounts for large governmental investors, such as PERS.

For a government's book entry securities to meet the "held in the name of the government" criterion, two conditions have to exist. First, the securities must be held in the book entry system in an account designated as a customer account. (Alternatively, the securities can be in a street name or nominee name account. As discussed in question 45, there is the presumption with the use of street and nominee names that another party may be the true beneficial owner.) Second, the member or participant custodian's internal records must identify the government as the owner or pledgee of the securities.

47. Q—If securities are in the Federal Reserve System or a depository book entry system, can the operator of the system be considered the custodian of the securities?

A—No, except for situations of joint custody of pledged securities. (See question 85 for an example of a joint custody arrangement.) Book entry system operators do not control the movement of securities among members or participants or among a member's or participant's separate accounts. The systems are simply the "vault" in which securities are held. (See question 2 of GASB TB 87-1 in Appendix 3.) Instead, the custodian of book entry securities generally is the member or participant in whose account the securities are held. (See also question 50 on the use of correspondents.)

48. Q—What kinds of accounts can governments have in the Federal Reserve System?

A—Described below are the three types of accounts that permit governments to directly hold U.S. government and federal agency book entry securities. Governments can obtain detailed information about these accounts from the district banks of the Federal Reserve. (See also question 85 on Federal Reserve pledge accounts.)

*Book entry safekeeping accounts for state treasurers:* One financial officer of a state, generally the state treasurer, may have up to two accounts in only one Federal Reserve Bank or Branch for the safekeeping of securities—an investment account for the state's own securities and a customer account for the securities of the local governments in the state. Except as discussed below, the states are not allowed to have accounts with which to make funds (cash) transactions. Therefore, for the

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state to purchase or sell securities at the same time it delivers or receives cash, the state has to work through the accounts of a financial institution that has both a funds account and a securities account with the Federal Reserve. Securities purchased and sold have to be transferred between the state's safekeeping account and the financial institution's securities account. Because of this, safekeeping accounts are practical only for securities that are to be held on a long-term basis.

*TREASURY DIRECT:* Governments also may have accounts in the Treasury Department Bureau of Public Debt's book entry system known as TREASURY DIRECT. The TREASURY DIRECT system will maintain an account for any individual or organization. Like the state treasurers' safekeeping accounts, TREASURY DIRECT accounts cannot be used for cash transactions and are practical only for holding securities on a long-term basis.

*State-owned limited-purpose trust companies:* A state can form a limited-purpose trust company to obtain access to a Federal Reserve funds account for purposes of investing in and trading book entry securities. This account would enable the state to take or make delivery of book entry securities at the same time it delivers or receives cash without going through the accounts of a financial institution.

To have a funds account, a state must establish a limited-purpose trust company through an act of its legislature. The trust company must obtain a guaranty of its obligations from the state, and the state must waive its sovereign immunity for any claims the Federal Reserve has for any liability the trust company incurs with respect to the funds account.

49. Q—A government invests in commercial paper issued by a corporation. No paper certificate is issued; instead, the corporation operates a book entry system for those securities. Are these securities that are subject to credit risk classification? If so, how would the government classify this commercial paper in categories of credit risk?

A—Yes, book entry issues of commercial paper are securities for purposes of classifying investments in categories of credit risk. If the government is the owner of record on the book entry system of the issuer corporation, the investment should be classified in category 1 as “held by the government.” This classification would be the same as if the corporation had issued a securities certificate registered in the government's name. If the government is not the owner of record, classification should be evaluated the same as it would be with other book entry securities. (See question 46.)

### **The custodian's use of correspondents**

50. Q—What if the government's securities are not in the possession of the custodian; that is, what if the securities are in the possession of another party that serves as the custodian's custodian? What conditions have to be evaluated to properly classify the deposits and investments?

A—This is a fairly common situation because many financial institutions and broker-dealers use “correspondents” for custody of securities, both those they own and those they hold for clients. Usually, it is only necessary to add one additional step to evaluate the “held in the name of the government” criterion. To simplify the following discussion, the named custodian is referred to as “custodian A” and the correspondent is “custodian Z.”

For custodian A to be found to be holding the government's securities in the name of the government, custodian Z's records and procedures must recognize that the securities belong to custodian A's clients. Therefore, custodian Z must hold the securities in the name of custodian A for the benefit of custodian A's clients. For this to be true, two conditions must exist. First, custodian Z must hold the securities in bearer form, in street or nominee name, or in a customer account in a book entry system. Second, custodian Z's records must show that the securities are owned by custodian A's clients. That is, custodian A must be holding the securities in a street name, nominee name, or customer account with

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custodian Z. Custodian Z does not need to know which securities are owned by which of custodian A's individual clients.

If these two conditions *do not* exist, custodian A cannot be found to be holding the securities in the name of the government. This is because either (a) custodian Z is not holding in a custodial position for custodian A or (b) custodian Z believes the securities are owned by custodian A. In either case, the government's rights to the securities are not clear—and the government should classify the deposits or investments in category 3.

However, if custodian Z knows and acknowledges that specific securities are owned by or pledged to the government, this fact would improve the classification of deposits and investments from category 3 to category 2 when custodian A is the counterparty. This is because custodian Z is custodian A's agent holding in the government's name—a category 2 condition. However, in the absence of special arrangements, it is unlikely that a correspondent will know and acknowledge that specific securities are owned by or pledged to the government.

51. Q—A government purchases securities from Bank A and uses an unaffiliated Bank Z for custody. Bank Z is the government's regular custodial agent and holds the securities in the government's name. However, Bank Z uses Bank A as its correspondent for settlement of all transactions and safekeeping of all securities. Bank A is holding the securities for Bank Z on behalf of Bank Z's customers. Is this investment classified in category 1 because the securities are held by Bank Z, the government's agent? Or, instead, is it classified in category 3 because the government's securities are actually in the possession of Bank A, the counterparty?

A—The investment is classified in category 1 because Bank Z *is* performing the custody function for the government despite its use of Bank A as correspondent. The facts of the question show that Banks A and Z are unaffiliated and the government's use of Bank Z for custody and Bank Z's use of Bank A as a settlement and safekeeping agent are ordinary and regular business arrangements. In the absence of such ordinary and regular arrangements, however, the classification might differ.

### **Obtaining information about how securities are held**

52. Q—How does a government obtain information about how its securities are being held?

A—The government's investment officers and external investment advisers and managers should be able to supply much of the information that financial statement preparers need about how securities are being held. A custodian that is the government's agent also will be able to provide information about the form of securities (bearer, registered, or book entry) and whether correspondent custodians, street or nominee names, and custodial or fiduciary book entry accounts are being used. Safekeeping or trust receipts or some other notification from the custodian (such as periodic statements) and written confirmations with the custodian can provide information about whether its internal records identify the government as the owner or pledgee of securities.

If a custodian that is the counterparty's trust department or agent provides the government with notification about securities owned by or pledged to the government, that custodian should be able to provide the government with the necessary information about custodial operations.

If a custodian that is the counterparty's trust department or agent *does not* provide the government with safekeeping or trust notices, it also may not be a useful source of information about custodial operations. This is because the custodian may not be "holding in the government's name" and may not be aware that the government has a valid interest in the securities. In this situation, as well as situations in which the counterparty is the custodian, information can be obtained from or through the counterparty. Although the deposits and investments would be classified in category 3 in these

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situations, understanding the custodial operations will allow the government to be better informed about the nature of the credit risk in the arrangement.

## Language and Format of the Statement 3 Presentation

### Language of the Presentation

53. *Q*—Must the exact language of Statement 3 be used in the disclosure to describe the three categories of credit risk?

*A*—No, the language used in the standard need not be used; however, alternative language should be sufficiently descriptive and precise to communicate the information required by Statement 3 about *who* holds the securities and *how* they are held. (See also question 64.)

At times, however the alternative language that preparers use can be ambiguous or potentially misleading. For example, consider the disclosure that describes collateral securities as “held by an independent third-party custodian.” These deposits could be classified in any of the three categories depending on whether the third-party custodian is the agent of the government or the agent of the pledging financial institution, and whether the securities are held in the name of the government.

Alternative language that is sufficiently descriptive and precise usually adds to the language used in Statement 3 rather than replacing it. For example, suppose that collateral on deposits with financial institutions is held in a Federal Reserve pledge account. (See question 85 for a description of these pledge accounts.) To communicate that these deposits are classified in category 1, a preparer could disclose that “the entire bank balance of deposits is covered by FDIC insurance and by U.S. Treasury securities that are pledged as collateral and segregated by the Federal Reserve Bank in a pledge account. Because the Federal Reserve Bank will not release the collateral without the city’s approval, the collateral is held by the city’s agent in the city’s name.”

54. *Q*—Can the same language be used to describe the three categories of credit risk for both deposits and investments?

*A*—It is not advisable to use the same language because the categories are different for deposits than for investments. For example, category 1 for deposits is “insured or collateralized with securities held by the government or by its agent in the government’s name.” If that language also is used to describe category 1 for investments, it would not properly inform the financial statement user about insurance, registration, and custody of investment securities. Instead, category 1 for investments is “insured or registered, or the securities are held by the government or by its agent in the government’s name.”

### Format of the Presentation

55. *Q*—Most governments use a tabular format like that illustrated in the appendixes of Statement 3 to present investment types, market values, and the credit risk categories. Is a tabular format required?

*A*—No, a tabular format is not required, but it is generally understood by users and is a useful format for presenting complex information. If a government has only a few types of investments and the custodial arrangements are the same for most or all of their securities, the required information probably could be adequately communicated in narrative form.

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56. Q—Paragraph 69 of Statement 3 provides that some investment types, such as mutual funds, should be disclosed but not classified in categories of credit risk. How would these exempted investments be presented in a tabular format?

A—Investments subject to the paragraph 69 exemption (see question 22) were illustrated in a tabular format in Appendix B of GASB Statement 3 (in Appendix 3 of this guide) in what has come to be called “below the line” presentation. An example is shown below. As an alternative, the “below the line” investment types could be presented as part of a reconciliation between the Statement 3 note disclosure and the balance sheet, as discussed in question 58. However, many find the tabular format better for making the required disclosure of the market value of the “below the line” investment types.

	<u>Category 1</u>	<u>Category 2</u>	<u>Category 3</u>	<u>Carrying Amount</u>	<u>Market Value</u>
Type A	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX
Type B	—	XXX	XXX	XXX	XXX
Type C	—	XX	XX	XX	XX
	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>	XXX	XXX
Mutual funds				<u>XXX</u>	<u>XXX</u>
Total investments				<u>\$XXX</u>	<u>\$XXX</u>

57. Q—Can a government’s deposits and investments be disclosed in a single table, or are separate presentations required?

A—Separate presentations of deposits and investments are not required, but separating them overcomes some of the problems that can result from using common language, as discussed in question 54.

58. Q—Is a reconciliation from the Statement 3 disclosures to the balance sheet required? If it is, there appears to be a conflict between GASB Statement 3 and GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. Statement 9 provisions may result in balance sheet reporting of “cash and cash equivalents” that differs from deposits. How can a reconciliation between the Statement 3 disclosure and the balance sheet be accomplished given the provisions of Statement 9? How will the provisions of GASB Statement 14 affect the reconciliation?

A—Statement 3 *does not* require a reconciliation between the Statement 3 disclosures and the balance sheet. However, some preparers have presented one. The different perspectives on financial reporting taken by the GASB in Statements 3 and 9 may change the nature of the reconciliation, especially by adding some reconciling items. However, some preparers may continue to believe a reconciliation between the Statement 3 disclosures and the balance sheet would be useful to financial statement users.

If a government reports cash and cash equivalents in its balance sheet, that account might exclude some items that are treated in the Statement 3 disclosure as deposits, for example, nonnegotiable CDs with an original maturity over three months. Cash and cash equivalents also might include some items that are treated in the Statement 3 disclosure as investments, for example, commercial paper and bankers’ acceptances. Statement 9, footnote 5, also allows many investments in open-end mutual funds and external and internal cash management or investment pools to be reported as cash. These funds and pools are reported as investments in the Statement 3 disclosures. All of these items of difference, therefore, would be part of a reconciliation between the Statement 3 disclosures and the balance sheet if one is presented.

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As explained in question 116, the provisions of Statement 14 will result in separate Statement 3 disclosures for discretely presented component units. In addition, it is possible that not all of those component units will require Statement 3 disclosures. Because Statement 14 requires that disclosures distinguish between information pertaining to the primary government and that of its discretely presented component units, it follows that a reconciliation could similarly distinguish between the primary government and its discretely presented component units. If a primary government total column is presented on the balance sheet, the most likely approach would be to provide two reconciliations—one for the primary government (including its blended component units) and one for the relevant discretely presented component units.

### Specific Issues on Deposits with Financial Institutions

#### Valuation and Presentation Issues

59. Q—Should the classification of deposits with financial institutions be based on the bank balance or the book balance (carrying amount) of the deposits?

A—Paragraph 67, subsection b, of Statement 3 requires that the classifications be based on the bank balance. The bank balance of a deposit is the amount shown on the financial institution's records, and the book balance is the amount shown on the government's records. Differences, if any, result primarily from deposits in transit and outstanding checks. The bank balance—the amount for which the financial institutions actually are liable as of the government's financial reporting date—is the relevant amount. This disclosure is intended to communicate the credit risk associated with deposits at financial institutions. Classifying deposits based on the book balance would not achieve the objective of this disclosure.

60. Q—In disclosing credit risk classifications on deposits with financial institutions, should uncollected funds be included as part of the bank balance?

A—Conceptually, uncollected funds *should not* be included in the bank balance of deposits that are classified in categories of credit risk. As a practical matter, however, they often are. Uncollected funds arise when a government makes a deposit in a financial institution and the government's account is credited for the deposit, but the depository financial institution has not yet received the money from the payor's financial institution. The amount of such uncollected funds can be substantial, in some cases amounting to millions of dollars daily.

If the FDIC liquidates a financial institution, the authority of the liquidation trustee is limited to those funds actually in the possession of the financial institution at the time it enters into liquidation. Funds collected after that time would be returned to the depositor rather than placed in the pool of assets managed by the liquidation trustee. Therefore, uncollected funds are not subject to credit risk from the depository financial institution, and should not be considered part of the bank balance to be classified. (See also question 74.)

Governments often will not know precisely when their bank collects funds. Governments will know their posted balance. Balances are posted when deposits are made, and the posted balance would obviously include uncollected funds. Therefore, the posted balance would be greater than the collected funds balance.

Using the posted balance for credit risk classification often is a practical alternative to trying to determine the collected funds balance. If the posted balance is entirely insured or the financial institution, due to legal requirements, pledges collateral with a market value sufficient to cover the posted balance, the government could report the credit risk category of the posted balance with assurance that the collected balance is in the same category. However, if this approach results in

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reporting a portion of the posted balance as uncollateralized, and the preparer believes that a material portion of those uncollateralized deposits may represent uncollected funds, the preparer may wish to consult with the financial institution to determine the collected funds balance, so as not to misrepresent the credit risk exposure of the government's deposits.

Deposits made into an account often are not available for withdrawal for some period of time. Using the available balance as the bank balance also may be practical, provided that a financial institution's policy for making funds available to a government is consistent with the financial institution's collection of those funds. In some cases, however, it would not be appropriate to use the available balance. These would be cases in which the period between posting and availability of a deposit does not coincide with the actual collection of funds by the depository financial institution. As a result, the available balance may not include funds that have been collected, because of a lag between when a bank collects funds and when the bank allows its customers to use the funds. Therefore, the available balance may be less than the collected funds balance. Using the available balance in this situation would not fully report the government's credit risk exposure in deposits with financial institutions.

61. Q—In disclosing credit risk classifications on deposits with financial institutions, should accrued interest be included as part of the bank balance?

A—Yes, accrued interest should be included in the bank balance for purposes of credit risk classification. (See question 75 for FDIC coverage on accrued interest.)

Some might initially find this response inconsistent with the response to question 93 on investments, which indicates that accrued interest is not *required* to be part of the balance that is classified in categories of credit risk. However, the difference is because the investment disclosure is based on carrying amount, which may or may not include accrued interest, whereas the deposit disclosure is based on bank balance, which should measure the full liability a financial institution has for a government's deposits, including accrued interest.

62. Q—If the entire bank balance is in category 1, does a government need to indicate the amount of the deposits in financial institutions?

A—No. The government can simply describe the situation by stating, for example, "All deposits are insured" or "All deposits are collateralized with securities held by the government's agent in the government's name." Such a disclosure, which does not require the government to give either the book balance or the bank balance of the deposits, minimizes the practical problems associated with the differences between the two balances.

63. Q—How should governments value the collateral covering deposits for purposes of applying paragraph 67 of Statement 3? That is, should they use market value or par value?

A—Governments should use the market value of collateral rather than par value or any other measure. Using market value will express the amount of protection a government has to offset the credit risk associated with the deposits. Classifying deposits based on the par value of collateral would not achieve this objective.

64. Q—The third category of credit risk in paragraph 67 of Statement 3 is "uncollateralized." A parenthetical sentence explains that this category includes any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in the government's name. Does this mean that governments should use the language "uncollateralized" to characterize deposits that are collateralized in the manner described above?

A—There is a fundamental difference in risk between deposits that are not collateralized and those that are, even though the collateral is held by the pledging financial institution, or by its trust department or

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agent but not in the government's name. (If an uninsured deposit is not collateralized, a government has no security in the event of default. If an uninsured deposit is collateralized, a government does have security against such a default, even though custodial arrangements may pose potential risk.) Therefore, even though all of these situations are classified in category 3, a government's note disclosure could appropriately describe its particular situation.

For example, if a government's deposits are not collateralized, the note disclosure could describe category 3 as uncollateralized. If a government's deposits are collateralized but the custodial arrangements result in a category 3 classification, the government could use language that describes that situation, for example, "collateralized with securities held by the pledging financial institution." For the note to describe this condition as uncollateralized could mislead the reader about the nature of the risk. If a government has some deposits that are uncollateralized and some that are collateralized but in category 3 because of the custodial arrangements, the government's description of category 3 could indicate both conditions. Although Statement 3 does not require that the disclosure distinguish between those amounts that are collateralized and those that are not, the preparer could add that information to better help the financial statement user. That additional information could be presented in narrative or tabular form as follows. These presentations do not remove amounts from category 3; they only disaggregate the elements of category 3.

### Narrative:

Of the \$234,567 of bank deposits classified in category 3, \$123,456 is not collateralized and \$111,111 is collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in the government's name.

### Table:

	<b><u>Category 1</u></b>	<b><u>Category 2</u></b>	<b><u>Category 3</u></b>
Insured deposits	\$ 654,321	\$ —	\$ —
Uninsured deposits:			
Collateralized	543,210	432,109	111,111
Uncollateralized	<u>—</u>	<u>—</u>	<u>123,456</u>
Total deposits	<u>\$1,197,531</u>	<u>\$432,109</u>	<u>\$234,567</u>

### Deposit Insurance

65. Q—GASB Statement 3 requires deposits with financial institutions to be reported in category 1 if they are insured. What constitutes insurance for this purpose?

A—Paragraph 67, footnote 10, of Statement 3 states that deposit insurance includes federal deposit insurance, state deposit insurance, and those multiple financial institution collateral pools that insure public deposits. It also might include commercial insurance. Details about federal deposit insurance are addressed in questions 66-82, state deposit insurance in question 83, multiple financial institution collateral pools in question 89, and commercial insurance in question 84.

### ***Federal Deposit Insurance Corporation***

66. Q—What organization provides federal deposit insurance on deposits in banks and savings and loan associations?

A—The Federal Deposit Insurance Corporation (FDIC) provides federal deposit insurance for accounts maintained in FDIC-insured banks and savings and loan associations. FDIC insurance is backed by the full faith and credit of the U.S. government. Not all banks and savings and loan associations are insured by the FDIC. Those that are must display an official sign.

## [Completely Superseded]

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) transferred the responsibility for insuring deposits in savings and loan associations from the former Federal Savings and Loan Insurance Corporation (FSLIC) to the FDIC. FIRREA required the FDIC to adopt uniform deposit insurance regulations to eliminate differences in deposit insurance coverage for deposits in banks and savings and loan associations. For most accounts, these uniform rules took effect on July 29, 1990. Certificates of deposit and other time deposits are not affected until their first maturity date after July 29, 1990. Certain other provisions of the new rules are being phased in at later dates.

67. Q—What sources are available to determine FDIC coverage?

A—To obtain a general understanding of FDIC coverage, you may refer to a booklet published by the FDIC, “Your Insured Deposit: Questions & Answers.” For more specific information about coverage of public funds, you may wish to consult the Federal Deposit Insurance Act (12 United States Code [U.S.C.] 1811 et seq.) and the FDIC’s deposit insurance regulations (12 Code of Federal Regulations [C.F.R.] Part 330). FDIC responses to selected technical inquiries are available through several sources including the FDIC’s loose-leaf service titled “Federal Deposit Insurance Corporation Laws, Regulations, and Related Acts,” Commerce Clearing House’s *Federal Banking Law Reporter*, and the Lexis and Westlaw databases. It may also be helpful to discuss FDIC coverage with personnel from the government’s financial institution.

68. Q—What records are needed to receive proper FDIC insurance coverage?

A—The FDIC uses the deposit account records of the insured financial institution to determine ownership of funds. If the FDIC determines that those records are clear, they are binding on the depositor and no other records will be considered in determining ownership of funds.

Deposit account records include account ledgers, signature cards, certificates of deposit, passbooks, and other books and records of the insured financial institution (including computer records) that relate to the insured institution’s deposit-taking function. The FDIC does not rely on account statements, deposit slips, or canceled checks to determine ownership of funds for insurance purposes.

If amounts are held in a deposit account in a fiduciary capacity for others, FDIC coverage that recognizes the interests of the beneficial owners in the account *can* provide additional insurance. However, the deposit account records of the insured financial institution must specifically disclose the existence of the fiduciary relationship for the FDIC to recognize the interests of the beneficial owners in the account. Further, multiple levels of fiduciary relationships exist for some deposit accounts. That is, the owner of record with the financial institution may be holding the funds in a fiduciary capacity for others who may themselves be acting in fiduciary capacities for others. Section 330.4(b) of the FDIC’s regulations explains the recordkeeping required for insurance to cover the interests of the true beneficial owners of the funds in the deposit account. That section allows records maintained in good faith by the depositor or by some other person or entity on behalf of the depositor, such as a pension plan administrator, to provide details about the ownership interests of other parties in the account.

69. Q—What FDIC insurance coverage is available on government deposits?

A—The FDIC has specific regulations for insuring the deposits of a public unit, that is, a state, county, municipality, or a political subdivision of one of those entities. An official custodian of a public unit receives up to \$100,000 coverage for the aggregate of all interest-bearing accounts (for example, CDs and other time deposits and savings deposits) held in a single insured financial institution in the same state as the government. In addition, the official custodian of a public unit receives up to \$100,000 coverage for the aggregate of all non-interest-bearing accounts (for example, demand deposits) held at the same insured financial institution.

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The official custodian of funds, rather than the public unit itself, is insured as the depositor. An official custodian must have plenary or complete authority (which includes control) over the funds for which the custodian is appointed to serve. Control of public funds includes possession as well as the authority to establish accounts in insured financial institutions and to make deposits, withdrawals, and disbursements.

70. Q—Does FDIC coverage change if a public unit has deposits in insured financial institutions in a different state?

A—Deposits in an out-of-state insured institution have a single \$100,000 insurance limit, regardless of whether they are time, savings, or demand deposits.

71. Q—Does the number of accounts used by the public unit affect FDIC coverage?

A—Depositing funds belonging to the same public unit in separate accounts in the same insured financial institution solely for budgetary or accounting purposes does not increase coverage. For example, separate checking accounts established by a county treasurer in the same insured financial institution for the general fund and each of two special revenue funds are not separately insured. However, accounts in one insured financial institution are not aggregated with accounts in other insured financial institutions for purposes of determining FDIC coverage.

72. Q—How is FDIC coverage affected when a public unit has two or more custodians?

A—Each *official* custodian is insured separately from the others. However, not all custodians are *official* custodians as defined in the FDIC's regulations. If the exercise of authority or control over the funds requires action by or the consent of two or more custodians, they will be treated as one official custodian for the purposes of deposit insurance. Similarly, the FDIC insurance available to a public unit cannot be increased merely by naming additional custodians without giving them authority or control over that unit's funds.

73. Q—Are separately elected officials of a local government (for example, a county clerk, county sheriff, and county recorder) each considered to be an "official custodian" for purposes of FDIC coverage?

A—Only if they each have complete authority and control over funds. The definition of *official custodian* in the FDIC's regulations does not depend on whether the custodian is separately elected. However, in many cases, it is likely that the law providing for separately elected officials also provides for those officials to have complete authority and control over separate funds.

74. Q—When checks are deposited in an account with an insured bank or savings and loan association, it may take some time for the financial institution to collect the funds. What happens if an insured financial institution fails before the funds are collected? Does the FDIC provide coverage on uncollected funds?

A—Uncollected funds are included as part of the deposit and insured up to deposit limits. If the checks are returned unpaid (insufficient funds), the FDIC will require a refund of any deposit insurance payment with respect to the unpaid checks. To the extent that funds collected after closing represent a deposit in excess of the insurance limits, they are not considered to be assets of the receivership, but are passed through directly to the account holder. (See also question 60.)

75. Q—Does the bank balance covered by the FDIC include accrued interest?

A—Subject to the dollar limits of coverage, the FDIC insures interest unconditionally credited to the deposit account on the date of default and the ascertainable amount of interest accrued to that date.

76. Q—When deposits are held in a fiduciary capacity, they may be eligible for pass-through insurance of up to \$100,000 for each owner or beneficiary. What are the more commonly held governmental

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accounts that are eligible for pass-through insurance? Is this pass-through insurance separate from the coverage provided for other accounts held by the beneficiaries in the same insured financial institution?

A—Often, governments transfer money for bond principal and interest payments to a financial institution as trustee in advance of the payment due date. These monies frequently are placed in a deposit account. These deposits are eligible to be insured for up to \$100,000 for the interests of each bondholder, provided the FDIC's recordkeeping requirements are satisfied. (See question 68.) This coverage is separate from, and in addition to, FDIC coverage provided for the bondholders' other deposits in the same insured financial institution.

Pension plans also are eligible for pass-through insurance. Each pension plan participant's ascertainable, noncontingent interest (including both vested and nonvested interests) in a valid pension plan is insured up to \$100,000 in the aggregate for those accounts representing interests of the same participant in any pension plan established by the same employer, provided that the FDIC's recordkeeping requirements are satisfied. The participant's interest in those pension plan accounts will not be aggregated with other accounts maintained by that participant in the same insured financial institution. If any portion of a pension plan's deposits is not attributable to the noncontingent interests of the plan participants, that portion is considered to be an overfunding of the plan and will be aggregated and insured up to \$100,000, separate from any other deposits of the employer or plan participants.

For purposes of an insurance calculation, the value of an employee's noncontingent interest in a defined contribution plan is the beneficiary's account balance, including both employer and employee contributions. For a defined benefit plan, an employee's *noncontingent interest* is the present value of the beneficiary's interest in the plan, evaluated in accordance with the actuarial method of calculation ordinarily used under the plan. In making the calculation, all interests of beneficiaries in the plan are considered to be fully vested. The term noncontingent interest means an interest capable of determination without evaluation of contingencies except vesting contingencies and those covered by the present worth tables in the Federal Estate Tax Regulations. Projected salary increases are not included in the calculation of a noncontingent interest, although they often are considered in the funding of many defined benefit plans of public units. FDIC Advisory Opinion 88-51 provides more-detailed information on how FDIC insurance is calculated for public pension plan deposits, including how pension plan funds may be allocated so that the deposits are attributable only to the noncontingent interests of the plan participants.

Bank investment contracts also may be eligible for pass-through insurance. (See the discussion at question 92.)

77. Q—Is pass-through insurance available for deposits of funds of Internal Revenue Code (IRC) Section 457 deferred compensation plans?

A—No, except for certain grandfathered coverage. In the past, Section 457 plan accounts were insured differently depending on whether money was deposited in an FDIC-insured bank or in an FSLIC-insured savings and loan association. Before the enactment of FIRREA, FSLIC insurance covered Section 457 plan deposits in insured savings and loan associations up to \$100,000 per employee or participant. The FDIC's position has been and continues to be that it will insure such accounts at a single insured financial institution only up to \$100,000 per plan, separately from other deposits maintained by the employer at the same financial institution. However, a grandfather clause provides that, for Section 457 plans in existence as of July 29, 1990, any deposits at insured savings and loan associations—whether existing account balances, new money deposited, or interest earned—will be covered up to \$100,000 per participant until January 29, 1992 or the earliest maturity date of any time deposit after that date. These deposits will be insured separately from any other deposits maintained by the employer or the participants at the same savings and loan association.

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Legislation has been currently proposed in the U.S. Congress to reinstate pass-through insurance for Section 457 plans.

78. Q—How is FDIC coverage affected when the same individual acts as official custodian for more than one public unit?

A—The deposits of each public unit would be eligible for separate insurance. For example, consider a county treasurer who collects property taxes, a portion of which belongs to an independent public unit, such as a school district. Pending monthly disbursement to the public unit, the treasurer places the taxes in a separate account in the same insured financial institution in which he or she holds the county's deposits. The independent public unit's monies are eligible for \$100,000 of separate coverage.

If the county treasurer collects taxes for several independent public units and places all monies in a single deposit account, the monies of the several independent units are eligible for \$100,000 of separate coverage, provided that the FDIC recordkeeping requirements are met. (See question 68.)

79. Q—Some state treasurers manage investment pools for the benefit of their local governmental entities. Occasionally, these pools have some amounts in deposits with financial institutions. What is the FDIC coverage for deposits of such pools?

A—Each public unit participating in the pool is eligible for FDIC coverage of (a) up to \$100,000 for time and savings deposits and (b) up to \$100,000 for demand deposits for its actual ownership interest in properly designated accounts in an insured financial institution within the same state as the government.

Unless the state treasurer meets the FDIC's definition of "official custodian" for the individual public units, each public unit's actual interest in the deposits of the pool would be aggregated with its other deposits in the same financial institution for purposes of FDIC coverage. Generally, placing monies with a state treasurer for investment purposes would not confer on the treasurer the control and authority for those funds that is needed to meet the FDIC's definition of official custodian.

80. Q—How is FDIC coverage affected if two financial institutions merge with each other?

A—Because insurance limits are based on a depositor's funds in any one institution, coverage can change if two or more institutions holding a government's deposits merge. In this case, deposits from the two institutions continue to be separately insured for six months from the date that the merger takes effect. However, there are special considerations for CDs and other time deposits.

CDs will continue to be separately insured until the first maturity date after the end of the six-month transition period. CDs that mature during the six-month period and that are renewed for the same term and same dollar amount (with or without accrued interest) will continue to be separately insured until the first maturity date after the six-month period. Other renewals of CDs that mature during the six-month period will be separately insured only until the end of the original six-month period.

The FDIC's regulations for continuation of separate deposit insurance after mergers apply to situations in which the liabilities of one or more insured financial institutions are assumed by another insured financial institution, whether by merger, consolidation, other statutory assumption, or contract.

81. Q—Is it necessary to evaluate what FDIC coverage is available on a government's deposits with financial institutions? Is it possible just to classify up to \$100,000 of deposits in each insured financial institution in category 1, and classify the remainder depending on whether the deposits are collateralized and who holds the collateral and how?

A—A preparer should accurately determine insurance coverage if the conditions of collateralization would result in a category 2 or a category 3 classification. It would mislead the financial statement user to classify insured deposits in category 2 or category 3. However, if the bank balances of deposits are

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entirely collateralized with securities held by the government or by its agent in the government's name, there is no need to evaluate FDIC coverage. This is because the entire amount is already classified in category 1 as a result of the conditions of collateral.

### **National Credit Union Share Insurance Fund**

82. Q—Some states permit public funds to be deposited in credit unions. What organization provides federal deposit insurance on deposits in credit unions, and what is the coverage provided?

A—The National Credit Union Administration (NCUA), an independent agency of the U.S. government, provides insurance for accounts in member credit unions through the National Credit Union Share Insurance Fund (NCUSIF). NCUSIF coverage is similar in many ways to FDIC coverage, insuring accounts up to \$100,000 and providing separate coverage for accounts maintained in different rights or capacities or forms of ownership. However, there are at least two notable differences between NCUSIF and FDIC coverage of public funds. First, the NCUSIF *does not* separately insure interest-bearing and non-interest-bearing accounts in an insured credit union in the same state as the public unit. (See question 69.) Second, the NCUSIF provides insurance on deposits of IRC Section 457 deferred compensation plans in insured credit unions up to \$100,000 per employee or participant. (See question 77.) This coverage is separate from the insurance the NCUSIF provides on other accounts the employee or participant maintains in the same credit union.

Not all credit unions are insured by the NCUSIF; those that are must display an official sign. To obtain a general understanding of NCUSIF coverage, you may refer to a booklet published by the NCUA, "Your Insured Funds." For more specific information about coverage of public funds, you may wish to consult the NCUA rules and regulations relating to insurance coverage (12 C.F.R. Part 745).

### **State Insurance Funds**

83. Q—Deposits in some financial institutions are not federally insured; instead, they are covered by state insurance funds. Does such coverage allow the deposit to be reported in category 1?

A—Yes, coverage by state insurance funds places a deposit in category 1. However, there have been limited instances of state insurance funds that were unable to cover insured losses. If the state insurance fund is not covering losses, the deposits should not be reported as "insured."

### **Commercial Insurance**

84. Q—Can insurance or a surety bond provided by a commercial insurance company permit the presentation of deposits in category 1?

A—Although Statement 3 does not specifically provide for commercial insurance on deposits in financial institutions to be category 1, it does for brokerage accounts. Therefore, it would follow that commercial insurance on deposits in financial institutions could be eligible for category 1 presentation.

However, to be considered "category 1 insurance," the scope of coverage provided by a commercial insurance company would have to be substantially the same as that provided by federal deposit insurance. For the scope of coverage to be considered substantially the same, the same risks would have to be covered. That is, the insurance would have to cover all types of losses, not only certain types of losses (for example, only losses from theft).

## Special Collateral Arrangements

### **Federal Reserve Pledge Accounts**

85. Q—What is a Federal Reserve pledge account? In which category should deposits be classified if collateral securities are held in a Federal Reserve pledge account?

A—A Federal Reserve pledge account is an account in which securities have been segregated on the books of the Federal Reserve and identified as being pledged to a specific public entity with the Federal Reserve serving as the custodian. In this instance, the pledgee is known to the Federal Reserve, and the Federal Reserve provides pledge-related notices directly to the pledgee. The pledge account is in the name of the pledgor financial institution, but the pledgor does not have the ability to access the securities while they remain in the pledge account. Any release or substitution of pledged collateral can be done only with the permission of the pledgee government.

In the case of Federal Reserve pledge accounts, the Federal Reserve Bank acts as the government's agent and holds the collateral securities in the government's name. Therefore, deposits secured by collateral held in these accounts should be classified in category 1.

For information about using a Federal Reserve pledge account, governments should contact their investment advisers or managers, financial institutions, or district bank of the Federal Reserve.

86. Q—Can a Federal Reserve pledge account be used to hold securities underlying a repurchase agreement?

A—No. Pledge accounts are available to state and local governments only to hold collateral securing deposits with financial institutions.

### **Collateral Pools**

87. Q—What is a single financial institution collateral pool? What are the major issues a government must consider in classifying deposits that are secured by such a pool? Should any activity disclosures be made?

A—In a single financial institution collateral pool, one financial institution pledges a pool of collateral against all the public deposits it holds.

*A government's classification is the same as the pool's classification:* Classifying an individual government's uninsured deposits requires determining the classifications of all of the uninsured deposits secured by the pool and applying those classifications to the deposits of individual governments. For example, if the market value of pool collateral is equal to 90 percent of all uninsured public deposits held by the financial institution, and the collateral securities are held by the pledging financial institution's trust department in the name of the pool, the uninsured deposits of each government covered by the pool are 90 percent in category 2 and 10 percent in category 3.

*Who determines the classifications:* To determine the classification of deposits secured by a single financial institution collateral pool, one must determine the market value of the collateral in the pool and the total uninsured deposits covered by the pool. Generally, this is not information that an individual government can obtain or verify. Many jurisdictions have assigned a state official (for example, the state's banking commissioner or treasurer) the ability or the authority to administer collateral pools, and governments should contact that official to try to obtain the information they need to classify their deposits.

*How the securities are held:* Some have questioned how to meet the "held in the name of the government" criterion when collateral secures the deposits of more than one individual government.

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Some assume that because particular securities are not held in the name of particular entities, the criterion can never be met for pools, and all uninsured deposits covered by pools are always classified in category 3. This is not the case. Custodians of pooled collateral generally are required to hold the securities in the name of the collateral pool (that is, collectively for the governments secured by the collateral). Provided that this is the case and that an individual government is recognized by the custodian, pledging financial institution, or pool administrator (whichever maintains the “official” list of pool participants) as one of the governments covered by the collateral pool, the “held in the name of the government” criterion is met for that individual government.

*Who the securities custodian is:* Pooled collateral might be held by the pledging financial institution, automatically resulting in a category 3 classification for all uninsured deposits covered by the pool. Sometimes, the trust department of the pledging financial institution has custody of the pool securities, resulting in a category 2 classification, provided that the trust department holds the securities in the name of the pool and the value of the pool meets or exceeds the amount of uninsured deposits.

However, sometimes a third-party custodian holds the collateral. If this is the case, a determination must be made about whether the custodian is the pledging financial institution’s agent or, instead, the agent of the pool (and thus the agent of the governments secured by the pool). (See questions 29 and 30 for the discussion on determining whose agent a custodian is.) Once again, this is a determination best made on a pool-wide basis by the pool administrator. If the custodian acts as the agent of the pool administrator (for example, by obtaining the administrator’s approval for all releases of collateral), the uninsured deposits of all governments covered by the pool should be classified in category 1— because the collateral is held by the government’s agent in the government’s name.

*Activity during the period:* As discussed in question 113, paragraph 73 of Statement 3 requires additional disclosures if the category 3 positions of a government’s deposits during the period significantly exceeded the category 3 deposits as of the balance sheet date. If the conditions of a collateral pool always result in a category 3 classification (because the collateral is held by the pledging financial institution, or by its trust department or agent but not in the name of the pool), an individual government’s records of its own uninsured bank balances provide the information needed for this activity disclosure. However, if the conditions of who holds pool collateral and how it is held generally result in a category 1 or a category 2 classification, the need for an individual government to make the activity disclosure depends on whether the value of the collateral pool resulted in uncollateralized deposits during the period and whether, for the individual government, that amount was significant. This may be difficult to determine and, once again, needs to be determined on a pool-wide basis by the pool administrator. If the pooling arrangements permit depository financial institutions to pledge collateral based on other than current deposit balances (for example, if collateral is pledged based on the average daily deposit balances in the previous calendar quarter), there is a possibility of significant uncollateralized deposits during the period.

88. Q—Suppose a government that is covered by a collateral pool cannot obtain the information it needs to make certain Statement 3 disclosures, for example, because there is no state official with the ability or authority to act as a pool administrator. Should all deposits automatically be classified in category 3? How would a preparer’s inability to obtain information affect the required activity disclosures?

A—A government should not just place the deposits in category 3 by default, because to do so would be misleading. If a government cannot obtain the information necessary to determine the proper category for deposits covered by collateral pools, it should disclose that fact along with any important information regarding credit risk that it is able to provide.

If a government cannot obtain the information it needs for the activity disclosure (see question 87) but conditions are such that a significant amount of deposits may have been uncollateralized during the period, the facts of those conditions should be disclosed. As an example: “Collateral pledged to the pool

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is adjusted on the tenth day of each calendar quarter to equal 102 percent of the average uninsured public deposits in the preceding calendar quarter. Because the amount of collateral pledged to the pool is not based on actual deposit balances, the possibility exists for the uninsured deposits of the pool to exceed the value of the pool, resulting in uncollateralized (category 3) deposits. The state official administering the pool does not provide the city with information about whether there were uncollateralized deposits during the year. However, the pool administrator permits only financial institutions that meet strict standards of financial condition to pledge collateral on a pooled basis.”

89. Q—What is a multiple financial institution collateral pool? How should governments classify deposits that are collateralized by such a pool?

A—Multiple financial institution collateral pools were discussed in paragraph 11 of Statement 3. In a multiple financial institution collateral pool, a group of financial institutions holding public funds pledge collateral to a common pool. Statutes authorizing these pools specify the amount of collateral that must be pledged by each financial institution—usually a certain percentage of the uninsured public deposits it holds. If any member financial institution fails, the entire collateral pool becomes available to satisfy the claims of governmental entities.

In many jurisdictions that have multiple financial institution collateral pools, if the value of the pool’s collateral is inadequate to cover a loss, additional amounts would be assessed on a pro rata basis to the members of the pool to ensure that there will be no loss of public funds. As a result, a multiple financial institution collateral pool *that provides for additional assessments* is similar to deposit insurance. Deposits covered by such a pool should be classified in category 1 as “insured,” regardless of who holds the collateral or how it is held.

If a multiple financial institution collateral pool *cannot make additional assessments*, the deposits should be considered collateralized rather than insured. The extent to which the pool collateralizes those deposits is determined by comparing each individual member financial institution’s total uninsured public deposits with the market value of the pool’s assets. For example, if the pool’s asset value exceeds the total uninsured public deposits of an individual member financial institution, all uninsured public deposits with that financial institution should be considered fully collateralized. If, however, the pool’s value is only 50 percent of the total uninsured public deposits of a member financial institution, each of that financial institution’s uninsured public deposits would be only 50 percent collateralized. Evaluating a multiple financial institution collateral pool that cannot make additional assessments for purposes of classifying deposits in categories of credit risk involves many of the same issues and considerations as with a single financial institution collateral pool, discussed in questions 87–88.

### Specific Deposit Accounts

#### *Certificates of Deposit*

90. Q—For purposes of Statement 3 disclosures, is a certificate of deposit (CD) an investment or a deposit?

A—It depends on whether the CD is negotiable or nonnegotiable. Negotiable CDs are securities that normally are sold in \$1 million units and that can be traded in a secondary market—and should be treated as investments for purposes of Statement 3 disclosures. Nonnegotiable CDs are time deposits that are placed by depositors directly with financial institutions and that generally are subject to a penalty if redeemed before maturity—and should be treated as deposits for purposes of Statement 3 disclosures.

Confusion has arisen over this issue for two reasons. First, there are two different instruments that are termed *CDs*. The second reason for confusion about Statement 3 treatment of CDs is that governments

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often classify nonnegotiable CDs in the balance sheet as investments, leading to an inclination for similar treatment in the Statement 3 note disclosure.

Negotiable CDs are securities that are subject to custodial credit risk depending on who holds the securities and how they are held. Therefore, even though there is issuer risk relating to the financial institution's ability to redeem the negotiable CD when it matures, it is the custodial credit risk that is of primary concern in the Statement 3 disclosure. In addition, FDIC coverage of negotiable CDs does not affect the investment's classification by category of credit risk. This is because the FDIC insures against default by the CD issuer (the insured financial institution), not the custodian of the securities.

With the nonnegotiable CD, there is no piece of paper that, if lost or stolen, would affect the government's rights to its assets. Instead, the instrument exposes the government directly to the issuer risk of the deposit. Statement 3 requires disclosure of information about the extent to which deposit insurance and collateral minimize this issuer risk.

### **"Money Market" Accounts**

91. Q—What are the "money market" accounts offered by financial institutions? Are they like money market mutual funds, which are not subject to classification in categories of credit risk?

A—Financial institution "money market" accounts are simply deposits that pay interest at a rate that is set to make the accounts competitive with money market mutual funds. These money market accounts should be treated like any other deposit account for purposes of Statement 3, and classified in categories of credit risk depending on whether balances are insured or collateralized.

### **Bank Investment Contracts**

92. Q—What are bank investment contracts (BICs)? Should they be classified in categories of credit risk? If so, are there any special considerations for classification?

A—A BIC is a general obligation instrument issued by a bank, typically to a pension plan, that provides for a guaranteed return on principal over a specified period. Other types of financial institutions, for example, savings and loan associations, also issue investment contracts that, for purposes of applying Statement 3, are treated like BICs.

BICs and investment contracts with other types of financial institutions should be classified in categories of credit risk because they are *deposits with financial institutions*. BICs purchased by a pension plan may be eligible for FDIC pass-through insurance up to \$100,000 per plan participant. (Legislation has been proposed in the U.S. Congress to change FDIC coverage for BICs.) Some financial institutions pledge collateral to secure uninsured BICs.

(See question 110 for a discussion of guaranteed investment contracts [GICs]. Although a GIC is an instrument similar to a BIC, a GIC is treated differently than a BIC for purposes of applying Statement 3 because it is not a deposit with a financial institution.)

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## Specific Issues on Investments

### Valuation and Presentation Issues

93. Q—Are the amounts reported in each category of credit risk based on an investment type's carrying amount or its market value? Should the market value of investments include accrued interest?

A—Investments should be classified in the categories of credit risk based on carrying amount. Concerning accrued interest, if a government accrues interest in its investment account, the market value of the investment type should include the accrued interest. However, if interest is accrued in a separate receivable account, the market value of the investment reported in the Statement 3 disclosure should not include the value of accrued interest. This approach to accrued interest was illustrated in the example in Appendix B of Statement 3 (reproduced in Appendix 3 of this guide).

94. Q—What is the market value of a repurchase agreement? Is it related to the market value of the securities underlying the repurchase agreement? If not, is it important to know the market value of those securities?

A—The market value of a repurchase agreement generally is the principal plus accrued interest of the agreement. The market value of a repurchase agreement is not based on the value of the underlying securities.

However, the market value of the underlying securities is important for classifying the investment in categories of credit risk. If the market value of the securities is less than the carrying amount of the repurchase agreement, that shortfall represents an unsecured position, and that part should be reported in category 3.

95. Q—Some governments account for investment transactions on the trade date; others on the settlement date. What are *trade date* and *settlement date*? Does the use of one accounting method versus the other affect classification in categories of credit risk?

A—The trade date is the date an investment order is made. The settlement date is the date on which the investment is delivered or received in exchange for the cash payment. In purchases and sales of securities, it is normal for the order to be made on one day and settled at a later date. Settlement date accounting presents no difficulty in making Statement 3 disclosures. However, if a government uses trade date accounting, there are differences between the securities accounted for and the securities that are subject to custodial credit risk.

If a government uses trade date accounting, it accounts for investments that have been ordered, even though it has given no consideration and the securities remain in the possession of the counterparty pending settlement. Unsettled purchases should be classified in categories of credit risk only to the extent that the counterparty holds a deposit or margin account against them. The remainder of the investment presents no custodial credit risk and would be subject to the provisions of paragraph 69 of Statement 3, which indicates that a credit risk categorization is not possible. A government using trade date accounting also may have relieved its investment account of unsettled sales. Even though the government is not subject to market risk on those investments, it still is subject to custodial credit risk that could result in losses before settlement. Therefore, preparers using trade date accounting should consider making disclosures of securities sold but not yet settled in categories of credit risk.

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## Brokerage Insurance

### ***Securities Investor Protection Corporation***

96. Q—The Securities Investor Protection Corporation (SIPC) provides protection for cash and securities held in customer accounts by member broker-dealers. What basic protection does SIPC offer?

A—SIPC was created under federal law as a nonprofit, membership corporation, funded by its members. With some exceptions, all brokers and dealers registered with the Securities and Exchange Commission (SEC), other than banks registered as municipal securities dealers, automatically are members of SIPC. Members display the SIPC membership sign. General information about SIPC's protection is provided in a booklet, "How SIPC Protects You," which is available from SIPC and member broker-dealers. For more detailed information about SIPC protection, you may wish to refer to the Securities Investor Protection Act of 1970 (15 U.S.C. §78aaa et seq., as amended) and the SIPC regulations (17 C.F.R. Part 300).

When a member firm fails, SIPC may arrange a transfer of customer accounts to another member broker-dealer. In many cases (for example, where failed firms' records are inaccurate) account transfers are not feasible. SIPC then protects customer assets in the following manner:

- a. Customers of a failed firm receive all securities that are registered in their names or are in the process of being registered and that are not in negotiable form (for example, by endorsement).
- b. Customers then receive, on a pro rata basis, all remaining customer cash and securities held by the firm.
- c. If claims still remain after the above distributions, SIPC's funds are available to satisfy the remaining claims of each customer up to a maximum of \$500,000, including up to \$100,000 on claims for cash (as distinct from claims for securities).

SIPC protection does not cover declines in the market value of securities. Customer claims generally are valued as of the day that SIPC takes action to protect customer assets.

97. Q—What property does SIPC protect? Are repurchase and reverse repurchase agreements protected?

A—SIPC protects customers' cash and securities. Most types of securities, such as notes, stocks, bonds, debentures, and negotiable CDs, are subject to protection. SIPC also protects investment contracts and certificates of participation or interest in any oil, gas, or mineral royalty or lease if they are registered as securities with the SEC under the Securities Act of 1933. Warrants or rights to purchase, sell, or subscribe to the above securities and any other instruments commonly referred to as securities also are protected by SIPC. However, SIPC does not provide protection for investment contracts that are not SEC-registered securities or for any interest in a commodity, commodity contract, or commodity option.

Cash balances with broker-dealers are protected by SIPC if the money was deposited or left in a securities account to purchase securities. SIPC does not protect cash balances maintained solely to earn interest.

The Securities Investor Protection Act does not address whether repurchase and reverse repurchase agreements are protected, and SIPC holds the position that it does not provide protection for participants in repurchase and reverse repurchase agreements because they are not customers of the broker-dealers. For purposes of Statement 3 disclosures, these agreements should be considered ineligible for SIPC protection.

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98. Q—The FDIC provides pass-through insurance for deposit accounts held in a fiduciary capacity, such as those made by pension plans. (See question 76.) Does SIPC also provide pass-through protection?

A—No. SIPC has promulgated rules identifying “Accounts of `Separate’ Customers of SIPC Members” which are codified at 17 C.F.R. §300.100. Specifically, §300.104(b) provides that “[a] qualifying trust account held with a member shall be deemed held by a separate customer of the member distinct from the trustee, the testator or his estate, the settlor, or any beneficiary of the trust.” Thus, the measure of protection by SIPC is the single trust account, and not its beneficiaries.

99. Q—How does the existence of SIPC protection affect the classification of investments in categories of credit risk?

A—SIPC protection permits category 1 classification for up to \$500,000 of unregistered investments held by a counterparty broker-dealer. For example, assume a government maintains an account with its broker (a SIPC member) containing securities with a carrying amount of \$800,000. In determining the amount to disclose in category 1, the government first should determine whether any of the securities are registered in its name. Registered securities are placed in category 1 regardless of who holds the securities. Up to \$500,000 of the remaining unregistered securities also would be classified in category 1 by virtue of SIPC protection. Therefore, if the account includes \$200,000 of registered securities, \$700,000 of the investments in the account would be classified in category 1 and \$100,000 would be classified in category 3.

### **Commercial Insurance**

100. Q—Many broker-dealers have insurance to supplement SIPC protection for their customers. Paragraph 68 of Statement 3 indicates that such insurance permits category 1 presentation of investments. What kind of insurance coverage would permit investments to be classified in category 1?

A—Statement 3 does not describe the conditions of additional insurance coverage that would permit category 1 classification of a government’s investments. It is reasonable, however, that to be considered “category 1 insurance,” the scope of coverage provided by a commercial insurance company would have to be substantially the same as the protection provided by SIPC. For the scope of coverage to be considered substantially the same, the same risks would have to be covered. That is, the insurance would have to cover all types of broker-dealer failures, not only certain types of losses (for example, only losses from theft). Preparers also may need to evaluate whether other conditions exist that may make private-sector insurance dissimilar to SIPC protection and thus preclude category 1 presentation of the covered investments.

### **Specific Investment Instruments**

#### ***Mutual Funds and Unit Investment Trusts***

101. Q—What is a mutual fund? What is the difference between an open-end mutual fund and a closed-end mutual fund? What is a unit investment trust?

A—An investment company operates a mutual fund by selling shares of its stock to investors; it invests, on the shareholders’ behalf, in a diversified portfolio of securities. An open-end mutual fund creates new shares to meet investor demand; a closed-end fund has a constant number of shares. The value of an investment in an open-end fund depends directly on the value of the underlying portfolio; the value of an investment in a closed-end fund depends on the market supply and demand for the shares rather than directly on the value of the company’s portfolio. An open-end mutual fund generally does not issue certificates; instead, it sends out periodic statements showing deposits, withdrawals, and dividends credited to the investor’s account. A closed-end fund does issue certificates, and the securities are

## [Completely Superseded]

traded on a stock exchange. GASB Statement 3 used the term *mutual fund* to refer to an open-end fund.

A unit investment trust also holds a diversified portfolio of securities. Unlike a mutual fund, the portfolio of an investment trust is fixed; once structured, it is not actively managed, except for some limited surveillance. That is, cash received from income and maturing investments is not reinvested but is distributed to shareholders of the trust. Unit investment trust shares are securities and are traded.

102. Q—Are investments in mutual funds and unit investment trusts classified in categories of credit risk?

A—Shares in closed-end mutual funds and unit investment trusts are securities and should be classified depending on brokerage insurance and on who holds the securities and how they are held.

Open-end mutual funds are not securities and, according to paragraph 69 of Statement 3, should not be classified in categories of credit risk. The relationship between the investor in an open-end mutual fund and the investment company is a direct contractual relationship. There is no piece of paper or other evidence of ownership that, if lost or stolen, would result in a loss to the investor. Therefore, the government's investment is not directly subject to custodial credit risk. Certainly, the fund securities that provide the basis for the participant's income and protection of its principal can be subject to custodial credit risk. However, that is the *fund's* risk, not the individual investor's risk. (See also question 22.)

103. Q—In paragraph 29 of the Introduction and Background section, Statement 3 defines a mutual fund as an open-end investment company *registered with the SEC*. Some mutual funds are entities established under state law to serve local or special-purpose governments and have received a “no-action” letter from the SEC. Is a government's investment in such a fund exempt from credit risk classification?

A—Yes, investments in these funds are exempt from classification under the provisions of paragraph 69.

### **Investments Made by Other Governments**

#### **Investment pools**

104. Q—Many governments have investments in pools managed by another government, for example, a state treasurer's pool for local and special-purpose governments. Paragraph 69 of Statement 3 exempts the participating governments from classifying their pool investments in categories of credit risk. Does this lack of classification mean there is no risk to the participating governments?

A—No, not classifying investments in pools managed by other governments is not meant to imply that risk does not exist. However, as with investments in open-end mutual funds, a participating government's investment is not directly exposed to custodial credit risk; *the pool faces the custodial risk*. The pool's custodial credit risk will be disclosed in a GAAP financial report issued by the government managing the pool. Governments in the pool may make reference in their own financial statements to the financial statements that make Statement 3 disclosures for the pool.

105. Q—May a government classify an investment in a pool managed by another government in categories of credit risk?

A—Paragraph 69 of Statement 3 does not require the classification of investments in pools managed by other governments, but neither does it prohibit it. As discussed in question 107, if securities are held in the name of the government managing the investment, they should be treated as held in the name of the individual participating governments. Therefore, if an individual participating government chooses to classify its investment in the pool, it would do so according to the ratable or percentage classification of the securities of the pool as a whole on the same date. That is, if the pool's securities are 60 percent in category 1 and 40 percent in category 2 as of the pool's balance sheet date, a participating government

## [Completely Superseded]

would report 60 percent of its investment in the pool in category 1 and 40 percent in category 2 on the same date. However, this information may not be available for a participating government with a fiscal year-end that differs from the fiscal year-end of the pool. (A government with a different fiscal year-end *should not* use category information as of the pool's fiscal year-end to classify its investment in the pool.)

Further, if a government classifies its pool investment in categories of credit risk as of the balance sheet date, it also must comply with the provisions of paragraph 73 of Statement 3, which require disclosure if category 3 positions during the period significantly exceeded the amounts in that category as of the balance sheet date. (See question 113.)

106. *Q*—A single government is the dominant participant in an investment pool managed by another government, generally owning over 95 percent of the pool assets. This dominant participant influences the pool's investment policies and practices, and its financial condition is significantly affected by those policies and practices. Does paragraph 69 of Statement 3 exempt this dominant participating government from disclosure in categories of credit risk?

*A*—In this situation, a paragraph 69 exemption would be contrary to the spirit of Statement 3. The situation the GASB considered in providing the paragraph 69 exemption for investment pools was that of a state-wide local government investment pool managed by the state treasurer in which individual local governments have no control over the treasurer's policies and only a small interest in the total pool. In the situation described in this question, the dominant participant in substance controls the investment pool.

This dominant government should consider making all paragraph 68–required disclosures based on its share of the pool, including the pool's investments by type, categories of credit risk, and market value. At the least, the government should disclose its dominance in the pool and refer its financial statement users to the Statement 3 disclosure in the GAAP financial statements of the pool.

### **Individual investments**

107. *Q*—Suppose one government makes investments on behalf of other governments, but the investments are not made as a part of a pool. For example, suppose a county treasurer is responsible for investing for all school districts in the county, and the county treasurer purchases specific U.S. government securities for each district. Also, suppose the securities are held by the county treasurer's agent in the county's name—a category 1 classification from the county's perspective. Should the school districts classify these investments in categories of credit risk, or are they exempt from classification because of the provisions of paragraph 69 of Statement 3? If classification is required, what category are the securities classified in?

*A*—This type of investment situation is uncommon; usually, the investing government makes the investments on a pooled basis. However, when it does occur, the investments are subject to classification by the school districts because the districts own specific investments. Paragraph 69 provides an exception for pooling because a government investing in a pool does not own investments specifically identifiable to it, but owns a portion of a group of commonly owned investments.

Provided that the county treasurer's internal records identify the individual school districts as owners, the investments would be classified by the individual school districts in category 1—based on the county treasurer's classification. The school districts face only the same custodial credit risk that the treasurer faces. The county treasurer, functioning in his or her official capacity as investment manager for the districts, is not considered an outside party that poses custodial risk as a financial institution or broker-dealer performing the same function would; therefore, the treasurer should not be seen as a

## [Completely Superseded]

counterparty. If the county treasurer would classify the investments in category 2 or category 3, so should the school districts.

### **Section 457 Deferred Compensation Plan Assets**

108. Q—Does Statement 3 apply to IRC Section 457 deferred compensation plan assets? If so, what are the typical Section 457 plan investment options, and how are they classified?

A—As discussed in question 9, Statement 3 applies to all deposits and investments reported on the face of a government's financial statements, including IRC Section 457 deferred compensation plan assets. Section 457 plans typically allow participants to invest in annuity contracts, GICs (see question 110), and open-end mutual funds (see questions 101-102). These investment types are not classified in categories of credit risk because they are not securities. (See question 22.) If a Section 457 plan were to allow participants to invest in securities (for example, direct investments in U.S. government securities), those plan assets should be classified in credit risk categories. Some Section 457 plans also permit an investment option of deposits with financial institutions. Questions 77 and 82 discuss deposit insurance for Section 457 plan deposits.

### **Tri-Party Repurchase Agreements**

109. Q—What is a tri-party repurchase agreement, and how should such investments be classified in categories of credit risk?

A—In a tri-party repurchase agreement, the custodian serves as agent both of the buyer-lender and of the seller-borrower by agreeing, in the event of default by one, to protect the interests of the other. The custodian holds the securities underlying the agreement in the names of both repurchase agreement parties (the buyer-lender as pledgee and the seller-borrower as owner). If the government is a direct party to the tri-party agreement and the custodian is not the trust department of or affiliated with a financial institution that is the seller-borrower of the repurchase agreement, the government would classify its investment in category 1, provided that the market value of the underlying securities meets or exceeds the carrying amount of the repurchase agreement. (See question 94.) Many tri-party repurchase agreements result in category 1 classification.

If the government is a direct party to the tri-party agreement and the custodian *is* the trust department of a financial institution that is the seller-borrower of or an affiliate of the seller-borrower of the repurchase agreement, the government would classify its investment in category 2, provided that the market value of the underlying securities meets or exceeds the carrying amount of the repurchase agreement. If the custodian *is* an affiliate of a financial institution that is the seller-borrower of the repurchase agreement, the government would classify its investment in category 3.

Sometimes governments are not direct parties to a tri-party agreement. Instead, they purchase the investment through or from a financial institution or broker-dealer that is the buyer-lender in the tri-party agreement. Sometimes the government's investment is in an individual repurchase agreement. Other times, the government participates in a "repurchase agreement pool," purchasing only a portion of a repurchase agreement in which the financial institution or broker-dealer is the buyer-lender. The government would classify its investment in either of these repurchase agreement transactions in category 3. In these cases, the financial institution or broker-dealer that purchased the investment for or sold it to the government is the counterparty, and the securities are being held by the counterparty's agent in the counterparty's name.

# [Completely Superseded]

## **Guaranteed Investment Contracts**

110. Q—What are guaranteed investment contracts (GICs)? How are they classified in categories of credit risk?

A—A GIC is a general obligation instrument issued by an insurance company, typically to a pension plan, that provides for a guaranteed return on principal over a specified period. The general assets of the issuing company support the GIC. Investment contracts issued by noninsurance companies are similar in substance to GICs and, except for those issued by financial institutions, are treated like GICs for purposes of applying Statement 3. (Bank investment contracts [BICs] and investment contracts with other financial institutions are discussed in question 92.)

GICs are not classified in categories of credit risk because they are direct contractual investments and are not securities. (See question 22.)

## **Foreign Investments**

111. Q—Does Statement 3 apply to foreign investments? If so, how are foreign investments classified in categories of credit risk?

A—Yes, Statement 3 disclosures are required for investments made in foreign markets. To classify foreign investments in categories of credit risk, governments need to determine whether the investments are securities and, if so, identify the custodial arrangements. Specifically, governments should determine the mechanics of the clearing process, whether the securities are held in paper or book entry form, and the function of any intermediaries in the process. Some foreign markets use a depository system and others do not. The length of the settlement process varies greatly from market to market, with transactions in some markets taking months to settle. A government's custodian often uses correspondents to hold securities in the country where they were purchased. Governments with foreign investment portfolios should work with the portfolio managers or custodians to apply Statement 3 to their portfolio.

112. Q—What are the characteristics of some types of foreign investments held by governments?

A—A number of governments invest in obligations of international agencies, such as the World Bank and the Asian Development Bank. Most international agency securities are in the Federal Reserve book entry system and can be acquired and held in the same manner as a U.S. government obligation. (See question 46.)

Some governments also invest in Eurodollar CDs. Eurodollar CDs are issued by banks outside the United States, primarily in London, with interest and principal paid in U.S. dollars. Settlement of Eurodollar CDs issued in London is made by payment of funds in the United States, but the actual paper securities are left in London for safekeeping. (Eurodollar CDs are negotiable CDs. See the discussion of negotiable CDs in question 90.)

Some foreign stocks are owned by way of American Depositary Receipts (ADRs). ADRs are paper securities issued by U.S. banks. ADRs evidence the ownership of actual shares of foreign stocks held in the bank's foreign branches or with a foreign correspondent on behalf of the ADR holder. ADRs are traded on the major stock exchanges and in the Over-the-Counter (OTC) market. ADRs often are registered in the street name of securities firms and the nominee name of custodial agents and can be held in book entry form in securities depositories, such as the Depository Trust Company (DTC). (See question 46.)

## Other Disclosures and Issues

### Activity Disclosures

113. Q—Do Statement 3 disclosures of deposits and investments relate only to conditions as of the balance sheet date?

A—No, Statement 3 also has four specific activity disclosures. Paragraph 73 of Statement 3 requires disclosure if the category 3 positions of deposits or investments during the period significantly exceeded the amounts in those categories as of the balance sheet date. Only a brief statement of fact and cause is required; the higher amount need not be disclosed. Paragraph 74 of Statement 3 also requires disclosure of the types of investments that were made during the period but that were not owned as of the balance sheet date; no disclosure of the amount so invested is required. These two disclosures are required to ensure that users are made aware of important information about the government's portfolio and custodial arrangements that is not apparent from the information given as of year-end. The third activity disclosure is in paragraph 75 of Statement 3, which requires information to be disclosed about losses recognized during the period due to default by counterparties and amounts recovered from prior-period losses if not separately presented on the operating statement. The last activity disclosure is discussed in question 114.

### Disclosure of Violations

114. Q—Paragraph 66 of Statement 3 requires disclosure of significant violations during the period of any legal or contractual provisions for deposits and investments. Why is this disclosure required? Also, what is a *significant* violation, and how detailed should the disclosure be?

A—This disclosure arises from the basic governmental financial reporting principle of reporting compliance with finance-related legal or contractual provisions. (See question 13 for a discussion of what constitutes *legal* provisions.)

What constitutes a *significant* violation is a matter of judgment for the financial statement preparer. However, *significant* connotes qualitative as well as quantitative features. A significant violation would not necessarily be restricted to one that involves a large dollar investment or a large dollar risk of loss. Preparers need to look at the specific wording of the legal or contractual provisions, the reason for the provisions, the current political environment, whether such a violation would affect the actions or accountability assessment of the financial statements users, and whether the lack of control that allowed a small dollar violation potentially could allow a future violation involving a much larger dollar investment or larger dollar risk of loss. For example, suppose a government that is required by law to fully collateralize uninsured deposits had a small amount of uncollateralized deposits during the reporting period because it has no procedures to monitor the value of collateral. This situation could be considered a significant legal violation because the lack of procedures could result in higher levels of uncollateralized deposits in the future. Moreover, some believe any violations of legal provisions relating to collateral requirements and the use of nonauthorized investment types are inherently significant in a qualitative sense and should be disclosed, regardless of the dollar amount involved.

This disclosure should only be as detailed as needed to inform users. This disclosure was made in two sentences in the nonauthoritative illustrative example in Appendix B of Statement 3. (See Appendix 3 of this guide.)

115. Q—A government's IRC Section 457 deferred compensation plan includes an investment option that is not listed in statute as an allowable investment for the government's operating monies. Is this a violation of legal provisions that needs to be disclosed?

## [Completely Superseded]

A—Not necessarily. Having Section 457 plan investment options that differ from investment types that are legal for the government’s operating monies should not be considered a violation of the government’s investment authority as long as those investment types are authorized for the deferred compensation plan.

### **GASB Statement 14**

116. Q—GASB Statement 14 will result in certain changes in note disclosures. In general, what effect do the provisions of that Statement have on the GASB Statement 3 disclosures?

A—Paragraph 62 of Statement 14 states that one of the key aspects of the reporting entity concept is that users should be able to distinguish between the primary government and its component units. Thus, because the notes and required supplementary information are integral parts of the financial statements, they should distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units.

Paragraph 63 of Statement 14 provides that notes essential to fair presentation in the reporting entity general purpose financial statements encompass both of the following:

- a. The fund types and account groups of the primary government, including its blended component units.
- b. Individual discretely presented component units considering both:
  - (1) The unit’s significance relative to other discretely presented component units.
  - (2) The nature and significance of the unit’s relationship to the primary government.

Governments should make Statement 3 disclosures pertaining to the deposits and investments of the primary government and its blended component units. Determining if Statement 3 disclosures should be made for discretely presented component units is a matter of judgment and should be considered on a component unit-by-component unit basis. Statement 3 disclosures for discretely presented component units may be presented in the aggregate for all discretely presented component units or at some level of disaggregation. However, the Statement 3 disclosures for discretely presented component units should not be aggregated with those of the primary government.

A Statement 3 disclosure might be essential for one discretely presented component unit but not for another depending on the component unit’s significance relative to the total component units included in the component units column(s) and on the component unit’s relationship with the primary government. Conditions that indicate that a discretely presented component unit may need to make Statement 3 disclosures include:

- a. The component unit’s deposits and investments are significant to the total deposits and investments for all discretely presented component units.
- b. The component unit is included in the reporting entity because the primary government is obligated for the component unit’s deficits or debts. (See Statement 14, paragraphs 31–33.) In this situation, the potential for loss resulting from a component unit’s deposits and investments may directly affect the likelihood that the primary government will need to provide financial support to the component unit to subsidize its operations or honor its debt service requirements.

### **Subsequent Events**

117. Q—If a government changes its custodial arrangements after year-end, should that fact be disclosed? For example, suppose a change in custodians after year-end will move most of a government’s investments from category 3 to category 1 or from category 1 to category 3.

## [Completely Superseded]

A—A change in custodial arrangements after year-end that significantly changes the credit risk classification of future deposits or investments should be disclosed. Cod. Sec. 2300.[106]f (“Notes to Financial Statements”) requires significant effects of subsequent events to be disclosed. Other subsequent events with significant effects on the Statement 3 disclosure also should be disclosed.

### Different Fiscal Year-Ends

118. Q—How should a reporting entity present its Statement 3 disclosures if the fiscal year-end of the primary government differs from the fiscal year-end of one or more component units? Must information about the deposits and investments of component units, including credit risk categories, be presented as of the primary government’s fiscal year-end?

A—Cod. Sec. 2600.113 and .114 (“Reporting Entity and Component Unit Presentation and Disclosure”) and GASB Statement 14, paragraphs 59 and 60, provide guidance for reporting if the fiscal year-ends of the primary government and its component units are different. (GASB Statement 14 moves this guidance to Cod. Sec. 2600.122 and .123.) The reporting entity report should include the Statement 3 disclosures from the different fiscal year-ends. Presentation of component unit information as of the primary government’s fiscal year-end is not required.

### Reverse Repurchase Agreements

119. Q—Paragraph 81 of Statement 3 requires the separate display of assets and liabilities arising from reverse repurchase agreements. How is this applied if a government pools monies from several funds for investment purposes and it is the pool, rather than individual funds, that has the reverse repurchase agreements?

A—It would be appropriate to make a pro rata allocation of the assets and liabilities arising from reverse repurchase agreements to the various funds with equity in the pool. If the reverse repurchase agreement assets and liabilities are not ratably distributed to the funds, they would not appear on the financial statements, because an internal investment pool generally is not reported as a separate fund in the financial statements. If ratable allocation would be immaterial in some funds, the assets and liabilities arising from the agreements could be allocated to only those funds with material equity in the investment pool.

### Other Miscellaneous Issues

120. Q—Paragraph 68 of Statement 3 requires disclosure of carrying amount and market value by type of investment. Does a government need to disclose market value if it does not materially differ from carrying amount?

A—No. As discussed in the Preface of this Implementation Guide, the provisions of Statement 3 need not be applied to immaterial items. However, the fact that there is no material difference between carrying amount and market value should be stated.

Because Statement 3 requires market values to be disclosed by type of investment, the evaluation of materiality should be made at that level. That is, materiality *should not* be evaluated based on the investments as a whole. As a practical matter, a preparer probably should disclose market values of all investment types unless the differences are immaterial for all investment types and, consequently, for investments as a whole.

## [Completely Superseded]

121. *Q*—Are Statement 3 disclosures required in a report on a single fund or department or agency of an entity? For example, can a separate report on a state treasurer’s office omit Statement 3 disclosures?

*A*—If the report is being presented in accordance with GAAP, Statement 3 disclosures are required to be presented.

# [Completely Superseded]

## Appendix 1

### CREDIT RISK CLASSIFICATION CHECKLISTS

#### Investments, Except Repurchase Agreements

Paragraph 68 of Statement 3 requires certain investments to be classified in categories of credit risk. The following series of questions may be helpful for classifying many investment transactions. The classification of repurchase agreements is addressed in the series of questions starting on page 48. The question numbers shown parenthetically indicate the Q&As in this Implementation Guide that will help financial statement preparers determine whether that condition is met.

	<u>Yes</u>	<u>No</u>
A. Is the investment represented by securities? (questions 22, 56, 101–104, 108, and 110)	Go to B	These investments are not classified.
B. Are the securities covered by SIPC protection or other brokerage insurance? (questions 96–100)	Category 1	Go to C
C. Are the securities registered with the issuer in the government's name (and not in negotiable form, for example, by endorsement in blank)? (question 43)	Category 1	Go to D
D. Are the securities in the possession of the government, either physically or through its own book entry account? (questions 4 and 48–49)	Category 1	Go to E
E. Which of the following outside parties has possession of the securities, either physically or through a book entry account? (questions 24–40 and 47)		<u>Resolution</u>
1. The same party that sold them to or bought them for the government (the counterparty)		Category 3
2. The safekeeping department of the counterparty		Category 3
3. An affiliate of the counterparty financial institution		Category 3
4. The trust department of the counterparty financial institution		Go to F
5. The trust department of an affiliate of the counterparty financial institution		Go to F
6. A third party that is an agent only of the counterparty		Go to F
7. A third party that is an agent both of the counterparty and of the government, and that is not the trust department or an affiliate of the counterparty financial institution		Go to G
8. A third party that is an agent only of the government, and that is not the trust department or an affiliate of the counterparty financial institution		Go to G
9. Someone else		Go to H

## [Completely Superseded]

- F. The investments are classified in category 2 if they are “held in the name of the government.” Otherwise, they are in category 3. For an investment to be “held in the name of the government,” the custodian’s internal records should recognize the government as the owner of the securities. (questions 41–42) Further, if the securities are in paper form, they should be bearer securities or be registered in street or nominee name to be “held in the name of the government.” (questions 43–45) If the securities are in a book entry system, they should be held in a street name, nominee name, or customer account to be “held in the name of the government.” (questions 46 and 49)
- G. The investments are classified in category 1 if they are “held in the name of the government.” For an investment to be so held, the custodian’s internal records should recognize the government as the owner of the securities. (questions 41–42) Further, if the securities are in paper form, they should be bearer securities or be registered in street or nominee name to be “held in the name of the government.” (questions 43–45) If the securities are in a book entry system, they should be held in a street name, nominee name, or customer account to be “held in the name of the government.” (questions 46 and 49)
- H. If the securities are not in the possession of one of the parties listed earlier in E, they are likely in the possession of a party that is acting in an agency capacity (a “correspondent”) for one of those parties. If this correspondent knows that its customer is holding the securities for another party, but the correspondent’s internal records do not identify the government as the owner, the government’s investment would be classified as if the securities were in the possession of the correspondent’s customer. That is, the custodian’s use of a correspondent would not affect classification. However, if the correspondent does not know that its customer is holding the securities for another party but believes the customer is holding the securities for itself, the government’s investment would be classified in category 3. On the other hand, if the correspondent’s customer is a counterparty to the government’s investment transaction and the correspondent’s internal records identify the government as the owner, the government’s investment would be classified in category 2. (question 50)

### Deposits and Repurchase Agreements

Paragraphs 67 and 68 of Statement 3 require deposits and repurchase agreements to be classified in categories of credit risk. The following series of questions may be helpful for classifying many deposit transactions. It also can help to classify repurchase agreements, starting with step D. The question numbers shown parenthetically indicate the Q&As in this Implementation Guide that will help financial statement preparers determine whether that condition is met.

	<u>Yes</u>	<u>No</u>
A. Is the deposit insured by federal or other insurance, or by a multiple financial institution collateral pool that can make additional assessments to cover any loss? (questions 65–84 and 89)	Category 1	Go to B
B. Is the uninsured deposit collateralized? (question 4)	Go to C	Category 3
C. Are the collateral securities in a Federal Reserve pledge account? (question 85)	Category 1	Go to D
D. Are the securities in the possession of the government, either physically or through its own book entry account? (questions 4 and 48–49)	Category 1	Go to E

## [Completely Superseded]

- E. Which of the following outside parties has possession of the securities, either physically or through a book entry account? (questions 24–40 and 47)

### Resolution

- |  |            |
|--|------------|
| 1. The counterparty—that is, the pledging financial institution, the seller-borrower of the repurchase agreement, or the party that acquired the repurchase agreement for the government | Category 3 |
| 2. The safekeeping department of the counterparty  | Category 3 |
| 3. An affiliate of the counterparty financial institution  | Category 3 |
| 4. The trust department of the counterparty financial institution  | Go to F    |
| 5. The trust department of an affiliate of the counterparty financial institution  | Go to F    |
| 6. A third party that is an agent only of the counterparty   | Go to F    |
| 7. A third party that is an agent both of the counterparty and of the government, and that is not the trust department or an affiliate of the counterparty financial institution         | Go to G    |
| 8. A third party that is an agent only of the government, and that is not the trust department or an affiliate of the counterparty financial institution                                 | Go to G    |
| 9. Someone else  | Go to H    |
- F. The deposits or repurchase agreements are classified in category 2 if they are “held in the name of the government.” Otherwise, they are in category 3. For a deposit or repurchase agreement to be “held in the name of the government,” the custodian’s internal records should recognize the government as the pledgee of the securities. (questions 41–42) Further, if the securities are in a book entry system, they should be held in a street name, nominee name, or customer account to be “held in the name of the government.” (questions 46 and 87–89)
- G. The deposits or repurchase agreements are classified in category 1 if they are “held in the name of the government.” For a deposit or repurchase agreement to be so held, the custodian’s internal records should recognize the government as the pledgee of the securities. (questions 41–42) Further, if the securities are in a book entry system, they should be held in a street name, nominee name, or customer account to be “held in the name of the government.” (questions 46 and 87–89)
- H. If the securities are not in the possession of one of the parties listed earlier in E, they are likely in the possession of a party that is acting in an agency capacity (a “correspondent”) for one of those parties. If this correspondent knows that its customer is holding the securities for another party, but the correspondent’s internal records do not identify the government as the pledgee, the government’s deposits and repurchase agreements would be classified as if the securities were in the possession of the correspondent’s customer. That is, the custodian’s use of a correspondent would not affect classification. However, if the correspondent does not know that its customer is holding the securities for another party but believes the customer is holding the securities for itself, the government’s deposits and repurchase agreements would be classified in category 3. On the other hand, if the correspondent’s customer is a counterparty to the government’s deposit or repurchase agreement transaction and the correspondent’s internal records identify the government as the pledgee, the government’s deposits and repurchase agreements would be classified in category 2. (question 50)

[Completely Superseded]

## Appendix 2

### GLOSSARY

The following definitions were developed within the context of the material in this Implementation Guide. Other definitions useful in applying the provisions of Statement 3 are contained in Codification Section 150, “Investments,” paragraphs .501–.551.

#### Affiliates

Companies that are subsidiaries of a common parent or holding company. (See also Bank holding company.)

#### Agent

- a. Generally, a person or firm empowered to act for another. An agent is the substitute or representative of its principal and derives its authority from the principal.
- b. For purposes of classifying deposits and investments in the Statement 3 categories of credit risk, the term *agent* is meant within a narrow area of responsibility—that of *custodial agent only*. A government’s custodial agent has a contractual relationship with the government to hold, at the discretion of the government, securities owned by or pledged to the government. If a financial institution or broker-dealer is both the counterparty and the custodial agent in a transaction, its identity as the counterparty takes precedence for classification purposes.

#### Available balance

The amount of a demand deposit account balance that is available for withdrawal. Often, deposits made into an account are not available for withdrawal for some period of time. (See also **Collected balance**.)

#### Bank holding company

A company that controls one or more banks and also may own subsidiaries with operations closely related to banking. Generally, the Bank Holding Company Act provides that a holding company has control over a bank if it directly or indirectly owns, controls, or holds with power to vote 25 percent or more of the voting stock of a bank.

#### Bank investment contract (BIC)

A general obligation instrument issued by a bank, typically to a pension plan, that provides for a guaranteed return on principal over a specified period. Other types of financial institutions also issue investment contracts that, for purposes of Statement 3, are treated like BICs. (See also **Guaranteed investment contract**.)

#### Bearer securities

Securities whose owners are not registered on the books of the issuer, or registered securities that have been endorsed in blank. Bearer securities are payable to the holder.

#### Book entry system

A system that eliminates the need for physically moving bearer-form paper or re-registering securities certificates to transfer ownership. To allow securities to be owned and transferred, an accounting system is established for or by the securities issuer or by a central depository. Individual investors hold securities of the systems through the accounts of system members or participants.

#### Brokerage insurance

For purposes of Statement 3, brokerage insurance includes SIPC protection and commercial insurance. (See also **Securities Investor Protection Corporation**.)

#### Collateral

Security pledged by a financial institution to a governmental entity for its deposits.

# [Completely Superseded]

## **Collateral pool**

- a. *Single financial institution collateral pool.* A group of securities pledged by one financial institution against all the public deposits it holds.
- b. *Multiple financial institution collateral pool.* A group of securities pledged by various financial institutions to provide common collateral for their deposits of public funds.

## **Collected balance**

The amount of a deposit account represented by collected funds. Collected funds include only those deposits made by the account holder that have been received by the depository financial institution from the payor's financial institution. (See also **Available balance.**)

## **Counterparty**

- a. Generally, another party to a transaction. In the case of deposits and investments made by governments, a counterparty could be the issuer of securities, a financial institution holding a deposit, a broker-dealer selling securities, or a third party holding investment or collateral securities.
- b. For purposes of credit risk classification, a counterparty is the party that pledges collateral or repurchase agreement securities to the government, or that sells investments to or buys them for the government.

## **Credit risk**

- a. The risk that a counterparty to an investment transaction will not fulfill its obligations. Credit risk can be associated with the issuer of securities, with a financial institution holding deposits, or with a party holding investment or collateral securities. Credit risk exposure can be affected by a concentration of deposits or investments in any one investment type or with any one counterparty.
- b. The credit risk categories of Statement 3 are concerned with *custodial credit risk*, which is the risk that a government will not be able (1) to recover deposits if the depository financial institution fails or (2) to recover the value of investment or collateral securities that are in the possession of an outside party *if the counterparty to the investment or deposit transaction fails.* (See **Counterparty**, definition b.)

## **Custodian**

The entity responsible for possession and safeguarding of securities.

## **Customer account**

An account in a book entry system that indicates that the account owner does not own the securities but is holding them for someone else.

## **Deposit insurance**

Insurance on deposits with financial institutions. For purposes of Statement 3, deposit insurance includes:

- a. Federal deposit insurance funds, such as those maintained by the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUSIF).
- b. State deposit insurance funds.
- c. Multiple financial institution collateral pools that insure public deposits.
- d. Commercial insurance.

## **Deposits with financial institutions**

Deposit accounts in banks, savings and loan associations, and credit unions.

# [Completely Superseded]

## **Federal Deposit Insurance Corporation (FDIC)**

An independent federal agency that insures deposits in member banks and savings and loan associations.

## **Federal Reserve pledge account**

An account in which securities have been segregated on the books of the Federal Reserve and identified as being pledged to a specific public entity with the Federal Reserve serving as the custodian. In this instance, the pledgee is known to the Federal Reserve, and the Federal Reserve provides pledge-related notices directly to the pledgee. The pledge account is in the name of the pledgor financial institution, but the pledgor does not have the ability to access the securities while they remain in the pledge account. Any release or substitution of pledged collateral can be done only with the permission of the pledgee government.

## **Federal Savings and Loan Insurance Corporation (FSLIC)**

An independent federal agency that previously insured deposits in savings and loan associations. Federal deposit insurance for these deposits currently is provided by the FDIC.

## **Guaranteed investment contract (GIC)**

A general obligation instrument issued by an insurance company, typically to a pension plan, that provides for a guaranteed return on principal over a specified period. The general assets of the issuing company support the GIC. Investment contracts issued by noninsurance companies are similar in substance to GICs, and except for those issued by financial institutions, are treated like GICs for purposes of Statement 3. (See also **Bank investment contract**.)

## **Insurance**

For purposes of classification in credit risk category 1, insurance relates only to guarantees on the performance of the custodian. (See also **Brokerage insurance** and **Deposit insurance**.)

## **Investment**

Securities and other assets acquired primarily for the purpose of obtaining income or profit. Therefore, the purpose for acquiring a particular asset often is important to identifying it as an investment. However, for purposes of Statement 3, "investments" do not include interest-bearing receivables, interest-bearing deposits with financial institutions, or assets that yield income or profit through operations, such as fixed assets.

## **Investment types**

Investments are of different types when they take different forms. Different investment risks, such as market risk and issuer credit risk, are basic features that give one investment a different form another. Investment types illustrated in the nonauthoritative appendixes to Statement 3 include repurchase agreements, U.S. government securities, bankers' acceptances, commercial paper, and corporate bonds.

## **Legal provisions**

Requirements that carry the force of law, including those arising from constitutions, statutes, charters, ordinances, resolutions, governing body orders, and intergovernmental grant or contract regulations.

## **Market risk**

The risk that the market value of an investment, collateral protecting a deposit, or securities underlying a repurchase agreement will decline. Market risk is affected by the length to maturity of securities, the need and ability to liquidate securities before maturity, the extent that collateral exceeds the amount invested, and the frequency at which the amount of collateral is adjusted for changing market values.

# [Completely Superseded]

## **Mutual fund**

An investment company operates a mutual fund by selling shares of its stock to investors, and it invests, on the shareholders' behalf, in a diversified portfolio of securities.

- a. An open-end mutual fund creates new shares to meet investor demand, and the value of an investment in the fund depends directly on the value of the underlying portfolio. An open-end mutual fund generally does not issue certificates; instead, it sends out periodic statements showing deposits, withdrawals, and dividends credited to the investor's account. Investments in open-end mutual funds *are not* subject to classification in categories of credit risk.
- b. A closed-end mutual fund has a constant number of shares, and the value of an investment in the fund depends on the market supply and demand for the shares rather than directly on the value of the company's portfolio. A closed-end fund does issue certificates, and the securities are traded on a stock exchange. Investments in closed-end mutual funds *are* subject to classification in categories of credit risk.

## **National Credit Union Share Insurance Fund (NCUSIF)**

A fund administered by the National Credit Union Administration, an independent agency of the U.S. government, to provide deposit insurance for accounts in member credit unions.

## **Nominee name**

A term that denotes arrangements used principally by institutional investors, financial agents, and securities depositories for the registration of securities held by them for their own account or the account of customers. In most instances, the nominee is a partnership formed solely for the purpose of acting as the record holder of the securities.

## **Registered securities**

Securities that have the name of the owner written on their face. Registered securities cannot be negotiated except by the endorsement of the owner.

## **Repurchase agreement**

- a. An agreement in which a government (buyer-lender) transfers cash to a broker-dealer or financial institution (seller-borrower); the broker-dealer or financial institution transfers securities to the government and promises to repay the cash plus interest in exchange for the *same* securities.
- b. A generic term for an agreement in which a government (buyer-lender) transfers cash to a broker-dealer or financial institution (seller-borrower); the broker-dealer or financial institution transfers securities to the government and promises to repay the cash plus interest in exchange for the same securities (as in definition a, above) or for *different* securities.

## **Reverse repurchase agreement**

- a. An agreement in which a broker-dealer or financial institution (buyer-lender) transfers cash to a government (seller-borrower); the government transfers securities to the broker-dealer or financial institution and promises to repay the cash plus interest in exchange for the *same* securities.
- b. A generic term for an agreement in which a broker-dealer or financial institution (buyer-lender) transfers cash to a government (seller-borrower); the government transfers securities to the broker-dealer or financial institution and promises to repay the cash plus interest in exchange for the same securities (as in definition a, above) or for *different* securities.

## **Securities**

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

# [Completely Superseded]

## **Securities Investor Protection Corporation (SIPC)**

A nonprofit corporation funded by its member SEC-registered broker-dealers that protects customer accounts in the event of the financial failure of a member.

## **Street name**

A term used by the securities industry to denote securities registered or held in a book entry system in the name of a brokerage firm or its nominee. Such securities frequently belong to customers of the firm.

## **Tri-party repurchase agreement**

A repurchase agreement in which the custodian serves as agent both of the buyer-lender and of the seller-borrower by agreeing, in the event of default by one, to protect the interests of the other. The custodian holds the securities underlying the agreement in the names of both repurchase agreement parties (the buyer-lender as pledgee and the seller-borrower as owner).

## **Trust department**

A department of financial institutions, such as commercial banks, savings banks, and savings and loan associations, that is authorized by and regulated under various state and federal laws. Assets held by trust departments as custodial agents for outside parties are considered legally separate from the assets of the financial institution and are held strictly on a fiduciary basis. Nonfinancial institution broker-dealers do not have trust departments. Safekeeping departments are not trust departments.

## **Underlying securities**

Securities transferred in accordance with a repurchase–reverse repurchase agreement.

## **Unit investment trust**

A diversified portfolio of securities. The portfolio is fixed; once structured, it is not actively managed. Cash received from income and maturing investments is not reinvested but is distributed to shareholders of the trust. Unit investment trust shares are securities and are traded. Investments in unit trusts are subject to classification in categories of credit risk.

[Completely Superseded]

Appendix 3

**STANDARDS SECTION AND ILLUSTRATIVE APPENDIXES FROM GASB STATEMENT NO. 3, DEPOSITS WITH FINANCIAL INSTITUTIONS, INVESTMENTS (INCLUDING REPURCHASE AGREEMENTS), AND REVERSE REPURCHASE AGREEMENTS, AND TECHNICAL BULLETIN NO. 87-1, APPLYING PARAGRAPH 68 OF GASB STATEMENT 3**

**GASB Statement 3: Standards of Governmental Accounting and Financial Reporting**

**Required Note Disclosures for Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements**

63. Disclosures about deposits with financial institutions, investments (including repurchase agreements), and reverse repurchase agreements help users of state and local governmental financial statements assess the risks an entity takes in investing public funds. As explained more fully below, entities should make certain disclosures about:
- a. Legal or contractual provisions for deposits and investments, including repurchase agreements
  - b. Deposits and investments, including repurchase agreements, as of the balance sheet date and during the period
  - c. Legal or contractual provisions for reverse repurchase agreements
  - d. Reverse repurchase agreements as of the balance sheet date.
64. The disclosures required by this Statement should generally be made for the entity as a whole. Additional or separate disclosures for component units, pension trust funds, or other funds or fund types should be made in certain circumstances as discussed in paragraphs 65, 70, and 71. However, additional or separate presentation by fund or fund type is not precluded for any other disclosures required by this Statement.

***Legal or Contractual Provisions for Deposits and Investments, including Repurchase Agreements***

65. The entity should briefly describe in the notes to financial statements the types of investments authorized by legal or contractual provisions.<sup>9</sup> If the types of investments authorized for different funds, fund types, or component units differ significantly from those authorized for the oversight unit and those funds, fund types, or component units have material investment activity compared with the combined entity's investment activity, the differences in authorized investment types should be disclosed.
66. Significant violations during the period of legal or contractual provisions for deposits and investments (including provisions other than those disclosed in accordance with paragraph 65) should also be disclosed. For example, if state statutes require collateral on deposits to be held by the entity's independent third-party agent but the collateral was usually held by the pledging financial institution's trust department, that should be disclosed.

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<sup>9</sup> According to the GASB's [May 31, 1990] *Codification of Governmental Accounting and Financial Reporting Standards*, Section 1200, "Generally Accepted Accounting Principles and Legal Compliance," paragraph .104, legal provisions include those arising from constitutions, charters, ordinances, resolutions, governing body orders, and intergovernmental grant or contract regulations.

## [Completely Superseded]

### **Deposits and Investments, including Repurchase Agreements, as of the Balance Sheet Date and during the Period**

67. If the bank balances of deposits as of the balance sheet date are entirely insured<sup>10</sup> or collateralized with securities held by the entity or by its agent in the entity's name, that fact should be stated. If not, these disclosures should be made:
- a. Carrying amount of total deposits, if not separately displayed on the balance sheet
  - b. The amount of total bank balance classified in these three categories of credit risk:
    - (1) Insured or collateralized with securities held by the entity or by its agent in the entity's name
    - (2) Collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name
    - (3) Uncollateralized. (This includes any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in the entity's name.)
68. The carrying amount and market value<sup>11</sup> of investments (including repurchase agreements) as of the balance sheet date should be disclosed in total and for each type of investment. The disclosure of carrying amounts by type of investment should be classified in these three categories of credit risk:
- a. Insured (see paragraph 25)[<sup>\*</sup>] or registered,<sup>12</sup> or securities held by the entity or its agent in the entity's name
  - b. Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the entity's name
  - c. Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the entity's name. (This includes the portion of the carrying amount of any repurchase agreement that exceeds the market value of the underlying securities.)

The term *securities* as used in this paragraph includes securities underlying repurchase agreements and investment securities.

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<sup>10</sup> For purposes of this Statement, depository insurance includes:

- a. This subparagraph has been edited to reflect the restructuring of federal deposit insurance coverage.] Federal depository insurance funds, such as [that] maintained by the FDIC. . . . The FDIC . . . currently insure[s] up to \$100,000 per deposit. However, separately named accounts of a governmental entity in a single financial institution may not necessarily be treated as separate deposits for purposes of applying the \$100,000 limit. Because the amount of insurance coverage depends on the nature and purpose of the entity's separate accounts, the entity should investigate the extent to which it is covered by federal depository insurance at each financial institution.
- b. State depository insurance funds.
- c. Multiple financial institution collateral pools that insure public deposits. [Paragraph 11 states in part that in a multiple financial institution collateral pool, all financial institutions holding public funds pledge collateral to a common pool. Statutes authorizing these pools specify that the collateral pledged by each financial institution must equal a certain percentage of the uninsured public deposits it holds. If any member financial institution fails, the entire collateral pool becomes available to satisfy the claims of governmental entities. If the value of the pool's collateral is inadequate to cover a loss, additional amounts would be assessed on a pro rata basis to the members of the pool. The ability to make additional assessments, provided either by the pooling agreement or by statutes, ensures that there will be no loss of public funds. As a result, a multiple financial institution collateral pool that provides for additional assessments is similar to depository insurance. If a multiple financial institution collateral pool cannot make additional assessments, deposits should be considered collateralized rather than insured.]

<sup>11</sup> If the governmental entity has invested in a pool managed by another government, such as city monies in a state treasurer's investment pool, no disclosure of the individual deposits and investments of the pool is required by this Statement unless the entity owns specific, identifiable investment securities of the pool. Instead, the investment in the pool should be treated as a type of investment with a market value equal to the net realizable value of the entity's share of the pool based on the pool's valuation method.

<sup>\*</sup> [Paragraph 25 states that cash and 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 of 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.]

<sup>12</sup> Securities are considered registered for purposes of this Statement only if registered in the name of the governmental entity.

## [Completely Superseded]

69. The categories in paragraph 68 may not apply to all types of investments. In general, investments in pools managed by other governments or in mutual funds should be disclosed but not categorized because they are not evidenced by securities that exist in physical or book entry form. Securities underlying reverse repurchase agreements should also be disclosed but not categorized, because they are held by the buyer-lender.
70. If the credit risk to the oversight unit is not apparent because (a) the deposit or investment balances of component units, pension trust funds, or other funds are significant and (b) the mix of credit risk categories for those units or funds is significantly different from that of the oversight unit, additional or separate disclosures concerning credit risk categories should be made for those units or funds.
71. One of the requirements of paragraph 68 is disclosure of the carrying amount and market value of total investments of the combined entity as of the balance sheet date. However, unrealized investment losses in one or more component units or funds may not be apparent because of unrealized investment gains in the remaining funds. In those cases, for those component units or funds with unrealized investment losses, the carrying amount and market value of that unit's or fund's total investments should be disclosed.
72. For commitments as of the balance sheet date to resell securities under yield maintenance repurchase agreements, the carrying amount (if applicable) and market value as of the balance sheet date of the securities to be resold and a description of the terms of the agreements (such as settlement price ranges, agreed-on yields, maturity dates, and so forth) should be disclosed.
73. If the amount of an entity's "Uncollateralized" deposits (paragraph 67b(3)) or "Uninsured, unregistered securities held by the counterparty, or by its trust department or agent but not in the entity's name" (paragraph 68c) during the period significantly exceeded the amounts in those categories as of the balance sheet date, that fact and the causes should be briefly stated. The amounts in those categories during the period could have exceeded those as of the balance sheet date because of increased amounts of deposits or investments, changes in practices, changes in the mix of investment types, or for other reasons. For example, 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.<sup>13</sup>
74. The entity should also disclose the types of investments made during the period but not owned as of the balance sheet date. For example, if the entity invested in repurchase agreements throughout the period but had none as of the balance sheet date, that fact should be disclosed.
75. The entity should disclose losses recognized during the period due to default by counterparties to deposit or investment transactions and amounts recovered from prior-period losses if not separately displayed on the operating statement.

### ***Legal or Contractual Provisions for Reverse Repurchase Agreements***

76. 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.

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<sup>13</sup> In this situation, the entity would disclose that, due to significantly higher cash flows at certain times during the year, the entity's investment in overnight repurchase agreements for which the underlying securities were held by the counterparty increased significantly; as a result, the amounts that were "Uninsured and unregistered, with securities held by the counterparty, or its trust department or agent but not in the entity's name" at those times were substantially higher.

## [Completely Superseded]

77. Significant violations during the period of legal or contractual provisions for reverse repurchase agreements should be disclosed. For example, if state statutes require the proceeds from the agreements to be used only for investment purposes and the entity routinely uses the proceeds to finance operations, that fact should be disclosed.

### ***Reverse Repurchase Agreements as of the Balance Sheet Date***

78. For reverse repurchase agreements other than yield maintenance agreements outstanding as of the balance sheet date, the credit risk related to the agreements should be disclosed. Credit risk is calculated by comparing the aggregate amount of the reverse repurchase agreement obligations including accrued interest with the aggregate market value of the securities underlying those agreements including accrued interest.
79. 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 (such as settlement price ranges, agreed-on yields, maturity dates, and so forth) should be disclosed.
80. The entity should also disclose losses recognized during the period due to default by counterparties to reverse repurchase agreements and amounts recovered from prior-period losses if not separately displayed on the operating statement.

### **Accounting and Reporting Guidance for Repurchase and Reverse Repurchase Agreements**

81. The assets and liabilities arising from reverse repurchase and fixed coupon reverse repurchase agreements should not be netted on the balance sheet. These agreements should be reported as a fund liability captioned "Obligations under reverse repurchase agreements," and the underlying securities should be reported as "Investments."
82. Income from repurchase and fixed coupon repurchase agreements should be shown as interest income. The interest cost of reverse repurchase and fixed coupon reverse repurchase agreements should be reported as interest expenditure/expense. The interest cost associated with reverse repurchase or fixed coupon reverse repurchase agreements should not be netted with interest earned on any related investments.
83. Yield maintenance repurchase and reverse repurchase agreements should be accounted for as purchases and sales, and sales and purchases, of securities, respectively, and gains or losses should be recognized.

# [Completely Superseded]

## GASB Statement 3: Appendix B

### Illustration of Note Disclosure for Deposits, Investments, and Reverse Repurchase Agreements

114. This appendix illustrates disclosures required by this Statement. The facts assumed in this example are illustrative only and are not intended to modify or limit the requirements of this Statement or to indicate the Board's endorsement of the policies or practices shown. Application of the provisions of this Statement may require disclosures and formats other than those illustrated here.

#### Assumptions

**Balance Sheet.** The captions on the combined balance sheet related to cash and investments and the amounts in the Total (Memorandum Only) column are as follows:

	<b>Total (Memorandum Only)</b>
Equity in pooled cash and investments	\$109,151,000
Cash	1,129,000
Investments	<u>138,106,000</u>
	<u>\$248,386,000</u>

**Deposits.** All deposits are in a single financial institution and are carried at cost plus accrued interest.

	<b>Carrying Amount</b>	<b>Bank Balance</b>	<b>Fund</b>
Insured (FDIC)	\$ 100,000	\$ 100,000	Pool
Insured (FDIC)	100,000	100,000	Pension
Uninsured:			
Collateral held by City's agent in City's name	3,015,000	3,015,000	Pool
Collateral held by pledging bank's trust department in City's name	4,810,000	4,380,000	Pool
Uncollateralized	<u>1,029,000</u>	<u>1,683,000</u>	Pension
Total Deposits	<u>\$9,054,000</u>	<u>\$9,278,000</u>	

# [Completely Superseded]

## Assumptions (continued)

**Investments.** Investments in the City's cash and investment pool are stated at cost or amortized cost, plus accrued interest. Other investments are stated at cost or amortized cost with accrued interest shown under a separate caption on the balance sheet. Market values include accrued interest only if the carrying amounts do.

	<u>Carrying Amount</u>	<u>Market Value</u>	<u>Fund</u>
<b>Repurchase Agreements:</b>			
Agreement Number 1:			
Securities held by City's agent in City's name	\$ 23,207,000	\$ 23,207,000	Pool
Agreement Number 2:			
Securities held by dealer bank's trust department in City's name	5,004,000	5,004,000	
No underlying securities	<u>997,000</u>	<u>997,000</u>	
Total Agreement Number 2	<u>6,001,000</u>	<u>6,001,000</u>	Pool
Agreement Number 3:			
Securities held by dealer	<u>4,000,000</u>	<u>4,000,000</u>	Pension
Total Repurchase Agreements	<u>\$ 33,208,000</u>	<u>\$ 33,208,000</u>	
<b>Other Investments:</b>			
U.S. Treasury Bills:			
Held by broker-dealer under reverse repurchase agreements	\$ 41,649,000	\$ 41,903,000	Pool
U.S. Treasury Notes:			
Held by dealer, but subject to SIPC and other insurance	1,716,000	1,789,000	Debt service
	<u>5,149,000</u>	<u>5,369,000</u>	Capital projects
	<u>6,865,000</u>	<u>7,158,000</u>	
FHLMC-Participating Certificates:			
Held by broker-dealer under reverse repurchase agreements	31,619,000	28,929,000	Pension
Commercial Paper:			
Uninsured, unregistered, and held by City's agent in City's name	14,470,000	14,550,000	Pool
Bankers' Acceptances:			
Uninsured, unregistered, and held by dealer bank	14,880,000	14,906,000	Pool
Uninsured, unregistered, and held by dealer bank's trust department in City's name	41,574,000	41,800,000	Pension
Corporate Bonds:			
Registered and held by City's agent	54,048,000	46,128,000	Pension
Investment in State Treasurer's Investment Pool	<u>1,019,000</u>	<u>1,019,000</u>	Pool
Total Other Investments	<u>\$206,124,000</u>	<u>\$196,393,000</u>	
Total Investments	<u>\$239,332,000</u>	<u>\$229,601,000</u>	

# [Completely Superseded]

## Assumptions (continued)

### Reverse Repurchase Agreements:

Agreements	Underlying Securities												
\$41,399,000 received, to be repaid with interest of 7.49% on 1/20/X6	\$43,000,000 USTB maturing 2/20/X6; \$41,649,000 carrying amount, \$41,903,000 market value												
\$18,591,000 received, to be repaid with interest of 8.45% on 12/18/X5	\$10,000,000 FHLMC-PC 10½% maturing 5/1/Z9; \$19,000,000 FHLMC-PC 9¼% maturing 10/1/Z8; \$7,653,000 and \$13,505,000 carrying amount, respectively, \$7,313,000 and \$12,160,000 market value, respectively												
\$9,102,000 received, to be repaid with interest of 8.50% on 12/31/X5	\$15,000,000 FHLMC-PC 9¼% maturing 7/1/Z8; \$10,461,000 carrying amount, \$9,456,000 market value												
Total Agreements	Total Underlying Securities												
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">Proceeds</td> <td style="text-align: right; border-bottom: 1px solid black;">\$69,092,000</td> </tr> <tr> <td>Accrued Interest</td> <td style="text-align: right; border-bottom: 1px solid black;">453,000</td> </tr> <tr> <td>Obligation</td> <td style="text-align: right; border-bottom: 3px double black;">\$69,545,000</td> </tr> </table>	Proceeds	\$69,092,000	Accrued Interest	453,000	Obligation	\$69,545,000	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">Market Value</td> <td style="text-align: right; border-bottom: 1px solid black;">\$70,832,000</td> </tr> <tr> <td>Accrued Interest</td> <td style="text-align: right; border-bottom: 1px solid black;">252,000</td> </tr> <tr> <td>Market Value plus Accrued Interest</td> <td style="text-align: right; border-bottom: 3px double black;">\$71,084,000</td> </tr> </table>	Market Value	\$70,832,000	Accrued Interest	252,000	Market Value plus Accrued Interest	\$71,084,000
Proceeds	\$69,092,000												
Accrued Interest	453,000												
Obligation	\$69,545,000												
Market Value	\$70,832,000												
Accrued Interest	252,000												
Market Value plus Accrued Interest	\$71,084,000												

## [Completely Superseded]

**Note X: Equity in Pooled Cash and Investments, Cash, Investments, and Obligations under Reverse Repurchase Agreements\***

The City maintains a cash and investment pool that is available for use by all funds, except the pension trust fund. Each fund type's portion of this pool is displayed on the combined balance sheet as "Equity in pooled cash and investments." In addition, investments are separately held by several of the City's funds. The deposits and investments of the pension trust fund are held separately from those of other City funds.

**Deposits.** At year-end, the carrying amount of the City's deposits was \$9,054,000 and the bank balance was \$9,278,000. Of the bank balance, \$3,215,000 was covered by federal depository insurance or by collateral held by the City's agent in the City's name, \$4,380,000 was covered by collateral held in the pledging bank's trust department in the City's name, and \$1,683,000 was uninsured and uncollateralized. The uninsured and uncollateralized deposits are held by the pension trust fund.

Statutes require collateral pledged for pool deposits to be held in the City's name by the trust department of a bank other than the pledging bank; however, during the year the City often permitted collateral on the pool's deposits to be held in the City's name by the pledging bank's trust department.

**Investments.** Statutes authorize the City to invest in obligations of the U.S. Treasury, agencies, and instrumentalities, commercial paper rated A-1 by Standard & Poor's Corporation or P-1 by Moody's Commercial Paper Record, bankers' acceptances, repurchase agreements, and the state treasurer's investment pool. The City is also authorized to enter into reverse repurchase agreements. The pension trust fund is also authorized to invest in corporate bonds rated AA or better by Standard & Poor's Corporation or Aa or better by Moody's Bond Ratings.

The City's investments are categorized below to give an indication of the level of risk assumed by the entity at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the City or its agent in the City's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the [dealer bank's] trust department or agent in the City's name. Category 3 includes [repurchase agreements with no underlying securities and] uninsured and unregistered investments for which the securities are held by the [broker-dealer] or by [the dealer bank.†] . . .

	Category			Carrying Amount	Market Value
	1	2	3		
Repurchase agreements	\$23,207,000	\$ 5,004,000	\$ 4,997,000	\$ 33,208,000	\$ 33,208,000
U.S. Government securities	6,865,000	—	—	6,865,000	7,158,000
Bankers' acceptances	—	41,574,000	14,880,000	56,454,000	56,706,000
Commercial paper	14,470,000	—	—	14,470,000	14,550,000
Corporate bonds	<u>54,048,000</u>	<u>—</u>	<u>—</u>	<u>54,048,000</u>	<u>46,128,000</u>
	<u>\$98,590,000</u>	<u>\$46,578,000</u>	<u>\$19,877,000</u>	165,045,000	157,750,000
Investments held by broker-dealers under reverse repurchase agreements:					
U.S. Government securities				41,649,000	41,903,000
U.S. Instrumentality securities				31,619,000	28,929,000
Investment in state treasurer's investment pool				<u>1,019,000</u>	<u>1,019,000</u>
<b>Total Investments</b>				<u>\$239,332,000</u>	<u>\$229,601,000</u>

\*Explanation of the valuation of the carrying amounts of deposits and investments would be in the Summary of Significant Accounting Policies.

[†Note: This paragraph has been changed from the original language of the Statement 3 illustration to make it more precise.]

## [Completely Superseded]

The pension trust fund owns approximately 89 percent of the investments that are in category 2 and approximately 20 percent of the investments that are in category 3.

Statutes require that securities underlying repurchase agreements must have a market value of at least 102 percent of the cost of the repurchase agreement. The market value of securities underlying repurchase agreements fell significantly below this required level on a few occasions during the year, but no losses were incurred.

Due to significantly higher cash flows at certain times during the year, the City's investment in overnight repurchase agreements for which the underlying securities were held by the dealer increased significantly. As a result, the amounts that were in category 3 at those times were substantially higher than at year-end.

**Reverse Repurchase Agreements.** State statutes permit the City to enter into reverse repurchase agreements, that is, a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The market value of the securities underlying reverse repurchase agreements normally exceeds the cash received, providing the dealers a margin against a decline in market value of the securities. If the dealers default on their obligations to resell these securities to the City or provide securities or cash of equal value, the City would suffer an economic loss equal to the difference between the market value plus accrued interest of the underlying securities and the agreement obligation, including accrued interest. This credit exposure at year-end was \$1,539,000.

# [Completely Superseded]

## GASB Statement 3: Appendix C

### Illustration of Note Disclosure for Deposits and Investments

115. This appendix illustrates disclosures required by this Statement. The facts assumed in this example are illustrative only and are not intended to modify or limit the requirements of this Statement or to indicate the Board's endorsement of the policies or practices shown. Application of the provisions of this Statement may require disclosures and formats other than those illustrated here.

#### Assumptions

**Deposits.** Deposits are carried at cost plus accrued interest. The carrying amount of deposits is separately displayed on the balance sheet as "Cash."

	<u>Carrying Amount</u>	<u>Bank Balance</u>
Insured (FDIC)	\$100,000	\$100,000
Uninsured, collateral held by Town's agent in Town's name	<u>245,000</u>	<u>271,000</u>
Total Deposits	<u>\$345,000</u>	<u>\$371,000</u>

**Investments.** The Town's investment in the state treasurer's investment pool is stated at cost plus accrued interest. Commercial paper is stated at amortized cost.

	<u>Carrying Amount</u>	<u>Market Value</u>
Commercial paper Uninsured, unregistered, and held by Town's agent in Town's name	\$ 256,000	\$ 258,000
Investment in state treasurer's investment pool	<u>810,000</u>	<u>810,000</u>
Total Investments	<u>\$1,066,000</u>	<u>\$1,068,000</u>

#### Note Y: Cash and Investments\*

The Town's deposits at year-end were entirely covered by federal depository insurance or by collateral held by the Town's custodial bank in the Town's name.

Statutes authorize the Town to invest in obligations of the U.S. Treasury and U.S. agencies, bankers' acceptances, repurchase agreements, commercial paper rated A-1 by Standard & Poor's Corporation or P-1 by Moody's Commercial Paper Record, and the state treasurer's investment pool.

The Town's investments at year-end are shown below. All of the commercial paper was held by the Town's custodial bank in the Town's name. The Town also invested in bankers' acceptances and U.S. Treasury securities during the year.

	<u>Carrying Amount</u>	<u>Market Value</u>
Commercial paper	\$ 256,000	\$ 258,000
Investment in state treasurer's investment pool	<u>810,000</u>	<u>810,000</u>
Total Investments	<u>\$1,066,000</u>	<u>\$1,068,000</u>

\*Explanation of the valuation of the carrying amounts of deposits and investments would be in the Summary of Significant Accounting Policies.

# [Completely Superseded]

## GASB Technical Bulletin No. 87-1

### Question 1

1. Should a financial institution or broker-dealer that purchases securities for a governmental entity be considered a counterparty for the purposes of applying paragraph 68 of GASB Statement 3?

### Response

2. Yes. A financial institution or broker-dealer that acts as a purchasing agent by acquiring securities for an entity should be considered a counterparty for purposes of applying paragraph 68 of GASB Statement 3, whether the securities come from the institution's or broker-dealer's trading inventory or from the open market.

3. Paragraph 68 requires uninsured, unregistered investments (including repurchase agreements) to be classified in three credit risk categories based on *who* holds the securities (the governmental entity, the entity's agent, the counterparty's trust department or agent, or the counterparty) and, in the case of the counterparty's trust department or agent, *how* the securities are held (in the entity's name or not in the entity's name). Those three categories are:

- a. Securities held by the entity or its agent in the entity's name (category a)
- b. Securities held by the counterparty's trust department or agent in the entity's name (category b)
- c. Securities held by the counterparty, or by its trust department or agent but not in the entity's name (category c).

4. The term *agent* as used in paragraph 68 refers to a financial institution or broker-dealer that is a *custodial agent* only. A governmental entity's custodial agent has a contractual relationship with the entity to hold, at the discretion of the entity, securities owned by or pledged to the entity. If a financial institution or broker-dealer is both the governmental entity's counterparty and the custodial agent in a transaction, its identity as the counterparty takes precedence in classifying securities for purposes of paragraph 68.

5. The term *trust department* as used in paragraph 68 refers only to the trust departments of financial institutions such as commercial banks, savings banks, and savings and loan associations. Assets held by those trust departments as custodial agents for outside parties are considered legally separate from the assets of the financial institution and are held strictly on a fiduciary basis. Those trust departments are authorized by and regulated under various state and federal laws. Nonfinancial institution broker-dealers do not have trust departments. Safekeeping departments are not considered trust departments for the purpose of applying paragraph 68.

6. *Example 1:* A government instructs its broker to purchase \$800,000 of U.S. government securities. The broker purchases the securities, holds them 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 a) and \$300,000 as uninsured and unregistered, with securities held by the counterparty (category c).

7. *Example 2:* A governmental 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 b). 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 c).

## Question 2

8. Some governmental entities, through their custodial banks, use the Federal Reserve and the Depository Trust Company (DTC) book entry systems to hold their U.S. government, federal agency, and corporate securities. Those securities are not held by or registered in the name of the governmental entity, but are instead held in the custodian's account at the Federal Reserve or at the DTC. How does the use of these book entry systems affect the disclosure by credit risk category required by paragraph 68 of GASB Statement 3?

### Response

9. Governmental entities generally do not have their own accounts in the Federal Reserve or DTC book entry system; they have access to those systems through the accounts of Federal Reserve members or DTC participants.<sup>1</sup> Generally, only financial institutions and broker-dealers are members or participants. However, the fact that the Federal Reserve or DTC book entry system is used is not central to determining *who* holds the securities for purposes of applying GASB Statement 3. That is, the Federal Reserve or DTC generally should not be considered to be the party that holds the securities. Those systems are simply the "vault" in which the securities are held. The central question is, "In *whose* vault are the entity's securities held?" That is, is the custodian in whose Federal Reserve or DTC account the securities are held (i) the entity's agent, (ii) the counterparty's trust department or agent, or (iii) the counterparty? As discussed below, if the entity's access to the book entry systems is provided through the accounts of its custodial bank, the securities are classified in category a, provided that the custodian is an agent of the entity, is holding the securities in the name of the entity, and is not the counterparty (or the trust department of the counterparty) to the sale or pledge of those securities to the entity.

### Entity's Agent

10. If the custodian is the entity's agent, the securities should be classified in category a, provided this agency relationship is based on a contractual relationship between the entity and the custodian that identifies the custodian as the entity's agent, and the securities are held in the name of the entity. Holding securities "in the name of the entity" means establishing the entity's rights to the securities. The entity's rights to and claims on securities it owns should be unconditional. The entity's rights to and claims on securities underlying repurchase agreements should be unconditional in the event of default by the counterparty to the agreement. In the Federal Reserve or DTC book entry system, the conditions that indicate securities are held in the name of the entity include having the securities held in a custodial or fiduciary account and identified as owned by or pledged to the entity in the custodian's internal accounting records. A custodial or fiduciary account is an account maintained in the Federal Reserve or DTC system separate from the account holding the custodian's own securities. The use of a custodial or fiduciary account indicates that the securities are owned by or pledged to someone other than the custodian, although it may not indicate the identity of that party.

### Counterparty's Trust Department or Agent

11. If the custodian is the counterparty's trust department or agent, credit risk classification depends on *how* the securities are held. If the securities are held in the name of the entity, they should be classified in category b. Conditions that indicate whether securities are held in the name of the entity include the use of a separate custodial or fiduciary Federal Reserve or DTC account, identification of the securities as those of the entity in the custodian's internal accounting records, and the custodian's recognition of the entity's rights to the securities. If the custodian is not holding the securities in the name of the entity, the securities should be classified in category c.

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<sup>1</sup> Governmental entities may in certain situations maintain accounts in the Federal Reserve and Treasury book entry systems. These accounts do not have the flexibility of Federal Reserve member accounts and are generally used by governmental entities to hold securities on a long-term basis.

## Counterparty

12. If the custodian in whose *Federal Reserve* account the securities are kept is the counterparty to the *sale* or *pledging* of securities, those securities should be classified in category c, regardless of any other measures the custodian has taken to segregate the securities. If the custodian in whose DTC account the securities are kept is the counterparty to the *sale* of securities, those securities also should be classified in category c. However, as discussed below, different conditions and rights may exist in the case of securities *pledged* through DTC.

13. Pledging securities through the DTC book entry system involves a written agreement between DTC and the pledgee in which DTC agrees to follow the pledgee's instructions for handling those securities. The pledgee must be a DTC participant; therefore, entities must have a participant act on their behalf as the pledgee. DTC procedures and the written agreement between DTC and the pledgee provide that although pledged securities are initially placed in a segregated section of the pledgor's account, the pledgee has the right to demand that those securities be moved to its own account at any time and must approve any release of the pledge on the securities. In this situation, the securities should be considered to be in the pledgee's "vault" (that is, the pledgee has control) and should be classified in category a, b, or c, depending on *who* the pledgee is (the entity's agent or the counterparty's trust department or agent) and *how* the securities are held (in the entity's name or not in the entity's name).

[Completely Superseded]

# [Completely Superseded]

## Appendix 4

### ACRONYMS, ABBREVIATIONS, AND GASB DOCUMENTS

ADR	American Depository Receipts
BIC	Bank Investment contract
CD	Certificate of deposit
C.F.R.	Code of Federal Regulations
Cod. Sec.	Codification Section
Codification	<i>Codification of Governmental Accounting and Financial Reporting Standards, as of May 31, 1990</i>
DTC	Depository Trust Company
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally accepted accounting principles
GASB	Governmental Accounting Standards Board
GASB Statement 3	<i>Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements</i>
GASB Statement 9	<i>Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting</i>
GASB Statement 14	<i>The Financial Reporting Entity</i>
GASB TB 87-1	Technical Bulletin 87-1, <i>Applying Paragraph 68 of GASB Statement 3</i>
GIC	Guaranteed investment contract
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NOW	Negotiable order of withdrawal
OTC	Over-the-Counter market
PERS	Public employee retirement system
Q&As	Questions and Answers in this Implementation Guide
SEC	United States Securities and Exchange Commission
Section 457 plan	Internal Revenue Code Section 457 deferred compensation plan
SIPC	Securities Investor Protection Corporation
SSAP	Summary of significant accounting policies
U.S.C.	United States Code

[Completely Superseded]

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