

Appendix 2

STANDARDS SECTION FROM STATEMENT 40

Scope and Applicability of This Statement

2. This Statement establishes and modifies disclosure requirements related to investment risks: credit risk (including custodial credit risk and **concentrations of credit risk**), **interest rate risk**, and **foreign currency risk**. This Statement also establishes and modifies disclosure requirements for deposit risks: custodial credit risk and foreign currency risk. This Statement applies to all state and local governments.

3. This Statement supersedes the level of note disclosure detail requirements in paragraph 64 of Statement 3. It also rescinds paragraphs 70, 71, 73, and 74 of Statement 3 and amends glossary paragraph 116 of that Statement. It also supersedes the custodial credit risk disclosure requirements in paragraphs 67 through 69 of Statement 3 and paragraph 16 of Statement 28. In addition, it supersedes paragraphs 32d and 41c of Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*.

General Disclosure Principles

4. Unless otherwise required, investment disclosures should be organized by investment type, such as U.S. Treasuries, corporate bonds, or commercial paper. Dissimilar investments, such as U.S. Treasury bills and U.S. Treasury strips, should not be aggregated into a single investment type.

Level of Detail

5. Paragraph 64 of Statement 3 is superseded by the following:

The disclosures required by this Statement generally should be made for the primary government, including its blended component units. Risk disclosures should also be made for governmental and business-type activities, individual major funds, nonmajor funds in the aggregate, or fiduciary fund types when the risk exposures are significantly greater than the deposit and investment risks of the primary government. For example, a primary government's total investments may not be exposed to concentration risk. However, if the government's capital projects fund has all of its investments in one issuer of corporate bonds, disclosure should be made for the capital projects fund's exposure to a concentration of credit risk.

Deposit and Investment Policies

6. Governments should briefly describe their deposit or investment policies that are related to the risks this Statement requires to be disclosed. For example, if a government has an exposure to a concentration of credit risk, an investment policy disclosure regarding concentration of credit risk is required. Likewise, if a government has an investment denominated in a foreign currency, an investment policy disclosure regarding foreign investments is required. If a government has no deposit or investment policy that addresses a specific type of risk that it is exposed to, the disclosure should indicate that fact.

Disclosures for Specific Risks

Credit Risk

7. Governments should provide information about the credit risk associated with their investments by disclosing the credit quality ratings of investments in debt securities as described by nationally recognized statistical rating organizations—rating agencies—as of the date of their financial statements (for example, by aggregating the amount of investments by rating categories). Unless there is information to the contrary, obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. Governments should disclose the credit quality ratings of external investment pools, money market funds, bond mutual funds, and other pooled investments of fixed-income securities in which they invest. If a credit quality disclosure is required and the investment is unrated, the disclosure should indicate that fact.

Additional Amendments to Statement 3

8. Paragraph 67 of Statement 3, with its related heading, is superseded by the following:

Custodial Credit Risk

Deposits are exposed to custodial credit risk if they are not covered by **depository insurance** and the deposits are:

- a. **Uncollateralized**,
- b. Collateralized with securities held by the pledging financial institution, or
- c. Collateralized with securities held by the pledging financial institution's trust department or agent but not in the depositor-government's name.

If a government has deposits at the end of the period that are exposed to custodial credit risk, it should disclose the amount of those bank balances, the fact that the balances are uninsured, and whether the balances are exposed on the basis of either a, b, or c above.

9. Paragraphs 68 and 69 and their related footnotes are superseded by the following:

Investment securities exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government, and are held by either:

- a. The **counterparty** or
- b. The counterparty's trust department or agent but not in the government's name.

If a government has investment securities at the end of the period that are exposed to custodial credit risk, it should disclose the investments' type, the reported amount, and how the investments are held. Investments in external investment pools and in open-end mutual funds are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form. Securities underlying reverse repurchase agreements are not exposed to custodial credit risk because they are held by the buyer-lender. The term *securities* as used in this paragraph includes securities underlying repurchase agreements and investment securities.

Amendment to Statement 28

10. Paragraph 16 of Statement 28 is superseded by the following:

Disclosures required by paragraph 9 of Statement No. 40, *Deposit and Investment Risk Disclosures*, should be made for securities lending collateral that is reported in the statement of net assets* and for the underlying securities, as discussed in this paragraph. Therefore, the reported amounts of these investments should be disclosed by type of investment and amount, as required by paragraph 4 of Statement 40.¹³

- a. Collateral that is reported in the statement of net assets should follow the custodial credit risk disclosure requirements of paragraph 9 of Statement 40, unless it has been invested in a securities lending collateral investment pool or another type of investment that is not exposed to custodial credit risk, as provided in that same paragraph.
- b. Underlying securities are not subject to custodial credit risk disclosure requirements if the collateral for those loans is reported in the statement of net assets.
- c. Underlying securities should follow the custodial credit risk disclosure requirements of paragraph 9 of Statement 40 if the collateral for those loans is not reported in the statement of net assets. This disclosure should be based on the type of collateral and the custodial arrangements for the collateral securities.

*For the purposes of this Statement, the statement of net assets also refers to the balance sheet.

¹³Cash collateral in deposit accounts with financial institutions is subject to the provisions of paragraph 8 of Statement 40.

Concentration of Credit Risk

11. Governments should provide information about the concentration of credit risk associated with their investments by disclosing, by amount and issuer, investments in any one issuer that represent 5 percent or more of total investments based on the level of detail prescribed in paragraph 5. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments are excluded from this requirement.

12. Paragraph 32d of Statement 25 is superseded by the following:

- d. Concentration of credit risk—Identification, by amount and issuer, of investments in any one issuer that represent 5 percent or more of plan net assets. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments are excluded from this requirement.

13. Paragraph 41c of Statement 25 is superseded by the following:

- c. Concentration of credit risk—Identification, by amount and issuer, of investments in any one issuer that represent 5 percent or more of plan net assets. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments are excluded from this requirement.

Interest Rate Risk

14. Governments should disclose information about the interest rate risk of their debt investments by using a disclosure method described in paragraph 15. Governments also should disclose the terms of investments with fair values that are highly sensitive to changes in interest rates.

15. Interest rate risk information should be organized by investment type and amount using one of the following methods:

- a. **Segmented time distribution**
- b. **Specific identification**
- c. **Weighted average maturity**
- d. **Duration**
- e. **Simulation model.**

Governments are encouraged to select the disclosure method that is most consistent with the method they use to identify and manage interest rate risk. If a method requires an assumption regarding timing of cash flows (for example, whether an investment is or is not assumed to be called), interest rate changes, or other factors that affect interest rate risk information, that assumption should be disclosed. Governments with investments in mutual funds, external investment pools, or other pooled investments that do not meet the definition of a 2a7-like pool should disclose interest rate risk information according to one of the methods above.

16. The terms of a debt investment may cause its fair value to be highly sensitive to interest rate changes. To the extent investment terms are not considered in the interest rate risk disclosure requirements of paragraph 15, the terms and fair value of that investment should be disclosed. Terms include such information as coupon multipliers, benchmark indexes, **reset dates**, and **embedded options**. Disclosure information for similar investments may be aggregated. Examples of highly sensitive investments and required disclosures are as follows:

- a. A **variable-rate investment's** coupon amount enhances or amplifies the effects of interest rate changes by greater than a one-to-one basis, such as 1.25 times the three-month London Interbank Offered Rate (LIBOR). The multiplier makes this investment's fair value highly sensitive to interest rate changes. This investment's fair value, its coupon's multiplier and benchmark index (1.25 times three-month LIBOR), and the frequency of the coupon's reset date should be disclosed.
- b. A variable-rate investment's coupon amount varies *inversely* with a benchmark index, such as 4 percent minus the three-month LIBOR with a floor of 1 percent. This investment's fair value, its coupon's multiplier and benchmark index (4 percent minus the three-month LIBOR with a floor of 1 percent), and the frequency of the coupon's reset dates should be disclosed.
- c. An asset-backed investment has repayments that are expected to significantly vary with interest rate changes. The variance may present itself in terms of variable repayment amounts, uncertain early or extended repayments, or in some cases, the possibility of no repayments. Interest-only and residual tranches of collateralized mortgage obligations are specific examples of such investments. This investment's fair value, the nature of its underlying assets, and the existence of the repayment option should be disclosed.

Foreign Currency Risk

17. If a government's deposits or investments are exposed to foreign currency risk, the government should disclose the U.S. dollar balances of such deposits or investments, organized by currency denomination and, if applicable, investment type.

EFFECTIVE DATE

18. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2004. Earlier application is encouraged.

**The provisions of this Statement need
not be applied to immaterial items.**