ILLUSTRATIVE FINANCIAL STATEMENT DISCLOSURES

The sample disclosures included in this appendix are presented to illustrate the disclosure requirements of Statement 40. These disclosures are illustrative only and are nonauthoritative. In some instances, amounts that may be considered immaterial are used to illustrate specific requirements or alternatives. No inferences about determining materiality should be drawn from these illustrations.

The illustrations in this appendix are based on the examples in Appendix C of Statement 40; however, some modifications have been made to better illustrate the requirements.

Other disclosure requirements, not covered in these illustrations, apply. For example, a summary of significant accounting policies, investments authorized by legal or contractual provisions, significant violations of legal or contractual provisions, and a government's steps taken to address such violations are required disclosures discussed in other authoritative accounting literature. NCGA Interpretation 6 and GASB Statement 38 describe many of those disclosure requirements.

Illustration 1

Credit Risk, Custodial Credit Risk, and Interest Rate Risk—Segmented Time Distribution and Callable Bonds

Assumptions

As of December 31, 2004, a city had the following investments in its internal investment pool. (Amounts are in thousands.)

Investment	Maturities	Fair Value
Repurchase agreements	January 2005	$ 15,000
U.S. Treasury	July 2005	62,000
U.S. Treasury	January–July 2006	42,864
U.S. Treasury	July 2011	15,000
U.S. agencies	Callable July 2005, scheduled maturity July 2009	15,000
U.S. agencies	November 2011	8,614
Commercial paper	March–September 2005	50,697
Corporate bonds	October 2006	10,000
Corporate bonds	July 2010–July 2012	20,493
Corporate bonds	July 2016	5,000
Mutual bond fund	Average maturity of the fund's portfolio: 9.5 months	74,420
Bankers' acceptances	June 2005	1,000
Total		$320,088

The city's investment policy limits at least half of the city's investment portfolio to maturities of less than one year. Investments with the following maturities are limited as follows:

Maturity	Maximum Investment
One to five years	35%
Six to ten years	15%
More than ten years	5%

The city assumes that its callable investments will not be called.

State law limits investments in commercial paper, corporate bonds, and mutual bond funds to the top two ratings issued by nationally recognized statistical rating organizations (NRSROs). City policy limits investments to the top rating issued by NRSROs. The city's investments in U.S. agencies all carry the explicit guarantee of the U.S. government.

Of the city's investments in repurchase agreements, underlying securities in the form of U.S. Treasuries of $2 million are held by the investment's counterparty, not in the name of the city. City policy limits securities underlying repurchase agreements to be held by counterparties to less than $5 million.

Disclosures

As of December 31, 2004, the city had the following investments and maturities. (Amounts are in thousands.)

		Investment Maturities (in Years)			
Investment Type	Fair Value	Less Than 1	1–5	6–10	More Than 10
Repurchase agreements	$ 15,000	$ 15,000	—	—	—
U.S. Treasuries	119,864	62,000	$42,864	$15,000	—
U.S. agencies	23,614	—	15,000*	8,614	—
Commercial paper	50,697	50,697	—	—	—
Corporate bonds	35,493	—	10,000	20,493	$5,000
Mutual bond fund	74,420	74,420	—	—	—
Bankers' acceptances	1,000	1,000	—	—	—
Total	$320,088	$203,117	$67,864	$44,107	$5,000

*These bonds mature July 2009, but are callable July 2005.

Interest Rate Risk. As a means of limiting its exposure to fair value losses arising from rising interest rates, the city's investment policy limits at least half of the city's investment portfolio to maturities of less than one year. Investment maturities are limited as follows:

Maturity	Maximum Investment
One to five years	35%
Six to ten years	15%
More than ten years	5%

Because the mutual bond fund as of December 31, 2004, had a weighted average maturity of 9.5 months, it was presented as an investment with a maturity of less than one year.

Credit Risk. State law limits investments in commercial paper and corporate bonds to the top two ratings issued by nationally recognized statistical rating organizations (NRSROs). It is the city's policy to limit its investments in these investment types to the top rating issued by NRSROs. As of December 31, 2004, the city's investments in commercial paper were rated A1 by Standard & Poor's, F-1 by Fitch Ratings, and P-1 by Moody's Investors Service. The city's investments in corporate bonds were rated AAA by Standard & Poor's and Fitch Ratings, and Aaa by Moody's Investors Service. The city's mutual bond fund investments were rated AAAf by Standard & Poor's and Aaa by Moody's Investors Service.

Custodial Credit Risk. For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the city will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. Of the city's $15 million investment in repurchase agreements, $2 million of underlying securities are held by the investment's counterparty, not in the name of the city. The city's investment policy limits holding of securities by counterparties to no more than $5 million.

Illustration 2

Credit Risk, Concentration of Credit Risk, and Interest Rate Risk—Specific Identification, No Investment Policy

Assumptions

A school district internally pools all of their investments with the exception of its investments in LEF Corporation bonds reported in the Capital Projects Fund. The district has not adopted a formal investment policy.

Disclosures

As of December 31, 2004, the district had the following investments. Except for the investment in LEF Corporation bonds, all investments are in an internal investment pool.

Investment	Maturities	Fair Value
State investment pool	6.5 months average	$1,506,980
U.S. Treasury bills	1/31/2005	452,980
Federal National Mortgage Association	3/31/2005	282,230
ABC Corporation commercial paper	1/31/2005	350,000
LEF Corporation bonds	3/31/2009*	50,000
Total		$2,642,190

*March 1, 2006 is the bond's call date.

Interest Rate Risk. The district does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

Credit Risk. State law limits investments in commercial paper, corporate bonds, and mutual bond funds to the top two ratings issued by nationally recognized statistical rating organizations. The district has no investment policy that would further limit its investment choices. As of December 31, 2004, the district's investment in the state investment pool was rated AAAm by Standard & Poor's and Aaa by Moody's Investors Service. The district's investment in ABC Corporation commercial paper was rated F-1 by Fitch Ratings, A1 by Standard & Poor's, and P-1 by Moody's Investors Service. The district's investments in Federal National Mortgage Association and LEF Corporation bonds were rated Aaa by Moody's Investors Service and AAA by Standard & Poor's and Fitch Ratings.

Concentration of Credit Risk. The district places no limit on the amount the district may invest in any one issuer. More than 5 percent of the district's investments are in ABC commercial paper and the Federal National Mortgage Association. These investments are 13.25% and 10.68%, respectively, of the district's total investments. All of the investments reported in the district's Capital Projects Fund are LEF Corporation bonds.

Illustration 3

Credit Risk; Interest Rate Risk—Weighted Average Maturity and Variable-Rate Coupons

The weighted average maturity (WAM) method expresses investment time horizons—the time when investments become due and payable—in years or months, weighted to reflect the dollar size of individual investments within an investment type. In this illustration, WAMs are computed for each investment type. The portfolio's WAM is derived by dollar-weighting the WAM for each investment type.

Assumptions

A city's investment policy limits the weighted average maturity of its investment portfolio to less than ten months.

An illustrative calculation of weighted average maturity for a city's corporate bond investments is as follows. Bond D carries a variable coupon that resets every quarter. Although the bond has a stated maturity of December 31, 2006, the city considers its maturity for interest rate risk purposes to be the length of time to its next reset date, three months.

Bond	Maturity Date	Time to Maturity (Years)	Maturity Amount	Calculation
A	6/30/2007	2.50	$ 30,000	0.47*
B	9/30/2008	3.75	15,000	0.35
C	12/31/2009	5.00	15,500	0.48
D	3/31/2005	0.25	100,000	0.16
Total			$160,500	1.46

*Calculated: 2.50 × ($30,000/$160,500).

All of the city's investments in U.S. agencies carry the explicit guarantee of the U.S. government. U.S. Treasury securities underlie repurchase agreements.

Disclosure

As of December 31, 2004, the city had the following investments:

Investment Type	Fair Value	Weighted Average Maturity (Years)
Repurchase agreements	$215,000	0.02
U.S. Treasuries	119,864	0.35
U.S. agencies	23,614	0.27
Commercial paper	55,493	0.52
Corporate bonds	160,500	1.46
Total fair value	$574,471	
Portfolio weighted average maturity		0.55

Interest Rate Risk. In accordance with its investment policy, the city manages its exposure to declines in fair values by limiting the weighted average maturity of its investment portfolio to less than ten months.

Credit Risk. State law limits investments in corporate debt to the top two ratings issued by nationally recognized statistical rating organizations. However, the city's investment policy limits its corporate debt investments to the top rating. The city's corporate bonds at December 31, 2004, are rated AAA by Fitch Ratings and Standard & Poor's, and Aaa by Moody's Investors Service. Its investments in commercial paper are rated P-1 by Moody's Investors Service, F-1 by Fitch Ratings, and A1 by Standard & Poor's.

Illustration 4

Interest Rate Risk—Duration; Credit Risk

> Duration is a measure of a fixed income's cash flows using present values, weighted for cash flows as a percentage of the investment's full price. Analytical software commonly includes duration functions. Macaulay duration—named after its developer—is the basic calculation developed for a portfolio of bonds assembled to fund a fixed liability. Modified duration—based on Macaulay duration—estimates the sensitivity of a bond's price to interest rate changes. Effective duration makes assumptions regarding the most likely timing and amounts of variable cash flows arising from such investments as callable bonds, prepayments, and variable-rate debt. This Statement does not specify which form of duration method is to be used.

Assumptions

As of December 31, 2004, a city had the following investments in its internal investment pool. (Amounts are in thousands. Modified duration is in years.)

Investment	Fair Value	Modified Duration
Repurchase agreements	$250,000	0.21
U.S. Treasuries	119,864	1.24
U.S. agencies	23,614	3.21
Taxable state bonds	10,000	1.83
Corporate bonds	90,500	0.68
Total fair value	$493,978	
Portfolio modified duration		0.72

The city uses a duration methodology to construct a portfolio of bonds to fund its future cash needs. For reporting purposes, it selects modified duration to disclose the portfolio's exposure to changes in interest rates.

Macaulay duration is calculated as illustrated in the following example: On December 31, 2004, a government has a $100 bond that matures on December 31, 2006. It carries a 7.5 percent coupon and has a yield-to-maturity of 7.5 percent.

Cash Flow Date	Term	Cash Flows	Present Value	Term × Present Value
6/30/2005	0.50	$ 3.75	$ 3.61	1.81
12/31/2005	1.00	3.75	3.48	3.48
6/30/2006	1.50	3.75	3.36	5.04
12/31/2006	2.00	103.75	89.54	179.08
			$100.00*	189.41

*Rounded.

Macaulay duration equals the sum of discounted time-weighted cash flows divided by the bond price:

$$189.41/\$100 = 1.89 \text{ years}$$

Modified duration is calculated as follows: Macaulay duration/(1 + yield-to-maturity/number of coupon payments per year). Continuing the example, modified duration would be:

$$1.8941/(1 + .075/2) = 1.83$$

Note: If the city's bonds carried call options, the city could consider the use of effective duration to allow for the consequences of variable cash flows.

As a charter city, the city's general investment policy is to apply the prudent-person rule: Investments are made as a prudent person would be expected to act, with discretion and intelligence, to seek reasonable income, preserve capital, and, in general, avoid speculative investments. The city's investment policy limits investments in corporate bonds to the top two ratings issued by nationally recognized statistical rating organizations. Through its investment policy, the city manages its exposure to fair value losses arising from increasing interest rates by limiting the modified duration of its investment portfolio to less than nine months (0.75 years).

Securities underlying repurchase agreements take the form of U.S. Treasuries.

Disclosure

As of December 31, 2004, the city had the following investments. (Amounts are in thousands. Modified duration is in years.)

Investment Type	Fair Value	Modified Duration
Repurchase agreements	$250,000	0.21
U.S. Treasuries	119,864	1.24
U.S. agencies	23,614	3.21
Taxable state bonds	10,000	1.83
Corporate bonds	90,500	0.68
Total fair value	$493,978	
Portfolio modified duration		0.72

Interest Rate Risk. Through its investment policy, the city manages its exposure to fair value losses arising from increasing interest rates by limiting the modified duration of its investment portfolio to less than nine months (0.75 years).

Credit Risk. As a charter city, the city's general investment policy is to apply the prudent-person rule: Investments are made as a prudent person would be expected to act, with discretion and intelligence, to seek reasonable income, preserve capital, and, in general, avoid speculative investments. The city's investment policy limits investments in corporate bonds to the top two ratings issued by nationally recognized statistical rating organizations. The city's investments in the bonds of U.S. agencies were rated AAA by Standard & Poor's and Fitch Ratings, and Aaa by Moody's Investors Service. The taxable state bonds were rated AAA/Aaa. Of the city's investments in corporate bonds, $80,500,000 was rated AAA/Aaa. The remaining corporate bond investment, $10 million, was rated AA/Aa.

Illustration 5

Interest Rate Risk—Simulation Model

> Simulation models estimate changes in an investment's or a portfolio's fair value, given hypothetical changes in interest rates. Various models and techniques may be used. The following example assumes that an adverse change in interest rates arises from an increase in interest rates. If the characteristics of the portfolio were such that a decrease in rates adversely affected fair value, then that scenario would be disclosed.

Assumptions

The following example illustrates the basic technique of using simulation models to value an investment or a portfolio. It assumes a change of interest rates of 100, 200, and 300 basis points; it also assumes that interest rate changes occur on January 1, 2005.

The following bonds, purchased December 31, 2004, mature in three years and were purchased at par. All coupon payments are made semiannually. The conventional bond has a coupon payment of 3 percent. The variable-rate bond resets at the London Interbank Offered Rate (LIBOR) quarterly. The inverse variable-rate bond's coupon varies by the difference of 6 percent minus LIBOR. For purposes of the variable-rate and inverse variable-rate bonds, the timing differences attributable to the reset date are not considered.

			Impact on Fair Value of Basis Point Increase of:		
	Fair Value	Cash Flows	100 Points	200 Points	300 Points
Conventional bond:					
3%	$1,000,000	$1,090,000			
4%	971,993	1,090,000	$ 971,993		
5%	944,919	1,090,000		$ 944,919	
6%	918,742	1,090,000			$ 918,742
Variable-rate bond:					
3%	1,000,000	1,090,000			
4%	1,000,000	1,120,000	1,000,000		
5%	1,000,000	1,150,000		1,000,000	
6%	1,000,000	1,180,000			1,000,000
Inverse variable-rate bond:					
3%	1,000,000	1,090,000			
4%	943,986	1,060,000	943,986		
5%	889,837	1,030,000		889,837	
6%	837,484	1,000,000			837,484
			$2,915,979	$2,834,756	$2,756,226

Disclosure

Interest Rate Risk. The following table summarizes the estimated effects of hypothetical increases in interest rates on investment fair values. It assumes that the increases occur immediately and uniformly to each type of investment. The hypothetical changes in market interest rates do not reflect what could be deemed best- or worst-case scenarios. Variations in market interest rates could produce significant changes in the timing of repayments due to any prepayment options. For these reasons, actual results might differ from those reflected in the table.

	Fair Value
December 31, 2004	$3,000,000
Fair value of portfolio after basis point increase of:	
100 points	2,915,979
200 points	2,834,756
300 points	2,756,226

Other disclosures would be required. For example, a schedule of investments by type, investment policies, and credit risk disclosures are not included in Illustration 5.

Illustration 6

Custodial Credit Risk—Deposits

Assumptions

A special-purpose government had the following depository accounts. All deposits are carried at cost plus accrued interest. The government does not have a deposit policy.

Depository Account	Bank Balance
Insured	$ 200,000
Collateralized:	
Collateral held by city's agent in the city's name	3,015,000
Collateral held by pledging bank's trust department in the city's name	4,380,000
Collateral held by pledging bank's trust department not in the city's name	500,000
Uninsured and uncollateralized	1,683,000
Total deposits	$9,778,000

Disclosure

Custodial Credit Risk—Deposits. Custodial credit risk is the risk that in the event of a bank failure, the government's deposits may not be returned to it. The government does not have a deposit policy for custodial credit risk. As of December 31, 2004, $2,183,000 of the government's bank balance of $9,778,000 was exposed to custodial credit risk as follows:

Uninsured and uncollateralized	$1,683,000
Uninsured and collateral held by pledging bank's trust department not in the city's name	500,000
Total	$2,183,000

Illustration 7

Investments with Fair Values That Are Highly Sensitive to Interest Rate Changes

The disclosures illustrated here also include those required by Technical Bulletin No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions.* Other disclosures may be required, such as credit risk and concentration of credit risk. Depending on the method used to communicate interest rate risk—for example, duration (paragraphs 14 and 15 of this Statement)—additional disclosures may be necessary.

Assumptions

In accordance with state investment laws, a county's external investment pool and pension system invest in various mortgage-backed securities, such as collateralized mortgage obligations, interest-only strips, and principal-only strips. The pension system also invests in investments that have coupon payments that vary inversely with changes in interest rates—inverse variable-rate investments—or vary according to changes in benchmark rates in greater than a one-for-one basis. These securities are reported at fair value in the statement of net assets.

As of December 31, 2004, the portfolios include the following investments that have fair values highly sensitive to interest rate changes.

Collateralized Mortgage Obligations. The pension system holds interest-only strips ($30,000,000 of the county's mortgage-backed securities position of $74,420,000) in part to maximize yields and as protection against a rise in interest rates. These securities are based on cash flows from interest payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgages, which may result from a decline in interest rates. The county's external investment pool holds principal-only strips ($45,580,000 of the pool's mortgage-backed securities position of $65,890,000) to reduce the price sensitivity of its fixed-income portfolio to changes in interest rates. These principal-only strips are sensitive to interest rate increases that may result from decreasing mortgage prepayments, thus increasing the average maturity of this investment.

Inverse Variable-Rate Note. The pension system invested $10 million in a structured note issued by the Federal National Mortgage Association. It was purchased at par on December 31, 2003, and matures December 31, 2006. The note's coupon payment varies inversely with movements in a benchmark rate. As interest rates increase, the coupon paid declines. The amount of the semiannual coupon is calculated at 7.25 percent minus the London Interbank Offered Rate (LIBOR). At December 31, 2004, the note had a fair value of $8,937,692. The following table summarizes changes in LIBOR and coupon payment:

		Coupon	
Date	**LIBOR**	**Annual Rate**	**Amount**
12/31/2003	3.625%	3.625%*	$181,250
12/31/2004	6.500%	0.750%	37,500

*Computed: 7.25% – 3.625% = 3.625%.

Variable-Coupon Note with Multiplier. The pension system invested $10 million in a structured note issued by the Federal Home Loan Bank. It was purchased on December 31, 2003, and matures December 31, 2006. The amount of the semiannual coupon is calculated at 1.25 times LIBOR plus 3 percent. The system's investment policy permits such investments with multipliers up to 1.50 times LIBOR or other index. At December 31, 2004, the note had a fair value of $10,854,465. The following table summarizes changes in LIBOR and the effect on the coupon payment:

		Coupon	
Date	LIBOR	Annual Rate	Amount
12/31/2003	3.625%	7.531%*	$376,550
12/31/2004	6.500%	11.125%	556,250

*Computed: (3.625% × 1.25) + 3%.

Disclosures

In accordance with state investment laws, the county's external investment pool and pension system invest in various mortgage-backed securities, such as collateralized mortgage obligations, interest-only strips, and principal-only strips. The pension system also invests in securities with coupon payments that vary inversely with changes in interest rates—inverse variable-rate securities—or vary according to changes in benchmark rates in greater than a one-for-one basis. These securities are reported at fair value in the statement of net assets.

Interest rate risk

Collateralized Mortgage Obligations. The pension system invests in interest-only strips ($30,000,000 of the system's mortgage-backed securities position of $74,420,000). These securities are based on cash flows from interest payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. The county's investment pool holds principal-only strips ($45,580,000 of the system's mortgage-backed securities position of $65,890,000). These principal-only strips are sensitive to interest rate increases that may result from decreasing mortgage prepayments, thus increasing the average maturity of this investment.

Inverse Variable-Rate Note. The pension system invested $10 million in a structured note issued by the Federal National Mortgage Association. It was purchased at par on December 31, 2003, and matures December 31, 2006. The amount of the semiannual coupon is calculated at 7.25 percent minus LIBOR. As interest rates increase, the coupon paid declines. At December 31, 2004, the note had a fair value of $8,937,692.

Variable-Coupon Note with Multiplier. The pension system purchased a $10 million structured note issued by the Federal Home Loan Bank. It was purchased on December 31, 2003, and matures December 31, 2006. The amount of the semiannual coupon is calculated at 1.25 times LIBOR plus 3 percent. The pool's investment policy permits such investments with multipliers up to 1.50 times LIBOR or other index. A variable coupon varies directly with movements in interest rates. At December 31, 2004, the note had a fair value of $10,854,465.

Illustration 8

Foreign Currency Risk

Assumptions

A pension system's exposure to foreign currency risk derives from its positions in foreign currency–denominated fixed-income investments and one investment in Canadian timberlands.

Disclosures

The system's exposure to foreign currency risk is as follows:

Investment	Currency	Maturity	Fair Value
XYZ Corporation bond	British pound	05/31/2005	$ 35,394,051
PQR Canadian government bond	Canadian dollar	01/04/2025	28,500,000
Timberlands	Canadian dollar	Not applicable	12,500,750
GHI Corporation bond	Swiss franc	11/01/2008	22,350,450
JKL Corporation bond	European euro	12/07/2008	19,211,000
MNO Corporation bond	Japanese yen	11/22/2006	15,500,000
Total			$133,456,251

The system's investments in foreign currency–denominated corporate bonds were rated AAA by Standard & Poor's and Fitch Ratings, and Aaa by Moody's Investors Service, consistent with its credit risk policy. The system's investment policy permits it to invest up to 9 percent of total investments in foreign currency–denominated investments. The system's current position is 6.5 percent.

Not presented in this illustration, among other investment disclosures, is the pension system's schedule of investments by type and by credit risk disclosures. If the system has entered into derivatives to manage its risks, additional disclosures may be required.

Illustration 9

Reverse Repurchase Agreements

The following example replaces the reverse repurchase agreement illustration in Statement 3, Appendix B.

Assumptions

State statutes permit the city to enter into reverse repurchase agreements. All sales of investments under reverse repurchase agreements are for fixed terms. In investing the proceeds of reverse repurchase agreements, city policy calls for the term to maturity of the investment to be the same as the term of the reverse repurchase agreement. Such matching existed at year-end.

As of December 31, 2004, outstanding reverse repurchase agreements were as follows. (All amounts are fair values.)

Agreement	Underlying Securities	Reinvestment
1. $41,399,000 received, to be repaid with interest of 2.49% on 1/20/2006	U.S. Treasury bond (USTB) 5⅝% maturing 2/20/2006, $41,903,000	$41,399,000 repurchase agreements ($18,500,000), commercial paper ($13,000,000), and bankers' acceptances maturing 1/20/2006 ($9,899,000)
2. $18,591,000 received, to be repaid with interest of 3.45% on 12/18/2005	Federal Home Loan Mortgage Corporation (FHLMC) 5½% maturing 5/1/2009, $7,313,000; FHLMC 9¼% maturing 10/1/2008, $12,160,000	$18,591,000 corporate bonds maturing 12/18/2005
3. $9,102,000 received, to be repaid with interest of 3.50% on 12/31/2005	FHLMC 4¼% maturing 7/1/2008, $9,456,000	$9,102,000 corporate bonds maturing 12/31/2005

The fair values of the underlying securities are as follows:

Agreement	Underlying Securities	Fair Value
1	USTB	$41,903,000
2	FHLMC 5½% 5/1/2009	7,313,000
	FHLMC 4¼% 10/1/2008	12,160,000
3	FHLMC 4¼% 7/1/2008	9,456,000
	Total FHLMC	28,929,000
Total underlying securities		70,832,000
Accrued interest		252,000
Fair value plus accrued interest		$71,084,000

The proceeds and subsequent reinvestments from these agreements are summarized as follows:

Agreement	Reinvestments	Total Agreements
1	Repurchase agreements	$18,500,000
	Commercial paper	13,000,000
	Bankers' acceptances	9,899,000
Total Agreement 1		41,399,000
2	Corporate bonds	18,591,000
3	Corporate bonds	9,102,000
Proceeds		69,092,000
Accrued interest		453,000
Obligation		$69,545,000

The city's credit exposure is as follows:

Underlying securities: fair value plus accrued interest	$71,084,000
Less reinvestments: fair value plus accrued interest	69,545,000
Credit exposure	$ 1,539,000

At the end of the reporting period, the city's investments are as follows. This schedule depicts investments not participating in the city's reverse repurchase agreement program, underlying securities used in reverse repurchase activities, and reinvestments that arise from proceeds of reverse repurchase agreements.

Investment	Not Participating	Underlying Securities	Reinvestment	Total
Repurchase agreements	$ 52,800,000	—	$18,500,000	$ 71,300,000
U.S. Treasury bonds	85,300,000	$41,903,000	—	127,203,000
U.S. government agencies	32,459,000	28,929,000	—	61,388,000
Bankers' acceptances	15,088,000	—	9,899,000	24,987,000
Commercial paper	25,654,000	—	13,000,000	38,654,000
Corporate bonds	38,357,000	—	27,693,000	66,050,000
Total	$249,658,000	$70,832,000	$69,092,000	$389,582,000

Disclosure

As of December 31, 2004, the city's investments were as follows:

Investment	Fair Value
Repurchase agreements	$ 71,300,000
U.S. Treasury bonds	127,203,000
U.S. government agencies	61,388,000
Bankers' acceptances	24,987,000
Commercial paper	38,654,000
Corporate bonds	66,050,000
Total	$389,582,000

Reverse Repurchase Agreements. State statutes permit the city to enter into reverse repurchase agreements. The credit exposure at year-end related to these agreements was $1,539,000. All sales of investments under reverse repurchase agreements are for fixed terms. In investing the proceeds of reverse repurchase agreements, city policy is for the term to maturity of the investment to be the same as the term of the reverse repurchase agreement. Such matching existed at year-end.

Not presented in this illustration, among other investment disclosures, are the city's interest rate and credit risk disclosures.

Illustration 10

Custodial Credit Risk—Securities Lending

The following three examples replace the illustrations in Statement 28, Appendixes C, D, and E.

Example A: Note Disclosure for Securities Lending Transactions—Cash Received as Collateral

Assumptions

A state employee retirement system administers two pension plans that have pooled domestic and international investment portfolios. Securities lending, which is authorized by state statutes and board of trustees policies, is managed by separate portfolio custodians, both of which are bank trust departments. All loans can be terminated on demand by either the system or the borrowers, although the average loan term is one week.

One agent lends the plan's U.S. government and agency securities and domestic corporate fixed-income and equity securities for cash collateral of 102 percent. This agent invests the cash collateral in a collateral investment pool that has share values based on the amortized cost of the pool's investments. At year-end, the pool has a weighted average term to maturity of twenty-eight days.

The other agent lends international corporate equity securities for cash collateral of 105 percent. The cash collateral is invested in overnight repurchase agreements in a separate account for the retirement system. There are no restrictions on the amount of securities that can be lent at one time or to one borrower.

Before the lending transactions and the investment of the cash collateral, the plan's aggregate investments are as shown in the following table. These investments are reported at fair value. Except for mutual funds, which are not subject to custodial credit risk, investments are held by the system's agent (which is not affiliated with or related to the investment brokers) in the system's name. (Amounts are in thousands.)

Investment Type	Fair Value
Mutual funds	$ 122,000
Repurchase agreements	750,000
Commercial paper	59,200
U.S. government and agency securities	1,612,800
Domestic corporate fixed-income securities	840,000
Domestic equities	1,720,000
International equities	825,000
Total	$5,929,000

The following represents the balances relating to the securities lending transactions as of December 31, 2004. (Amounts are in thousands; investments are reported at fair value.)

Securities Lent	Underlying Securities	Collateral Received	Collateral Investment Value	Type of Collateral
U.S. government and agency securities	$514,000	$525,000	$525,000	Custodian's short-term investment pool
Domestic corporate fixed-income securities	34,000	35,000	35,000	Custodian's short-term investment pool
Domestic equities	65,000	67,000	67,000	Custodian's short-term investment pool
International equities	215,000	226,000	226,050	Repurchase agreements
	$828,000	$853,000	$853,050	

Except for $226,050,000 of collateral invested in repurchase agreements, collateral is invested in investment pools and is not exposed to custodial credit risk. For the $226,050,000 repurchase agreement, the underlying securities are held by the counterparty—the securities lending agent.

Both lending agents provide indemnification if the borrowers fail to return the underlying securities (and if the collateral is inadequate to replace the securities lent) or fail to pay income distributions on them. There were no significant violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior-period losses during the year. There are no income distributions owing on the securities lent.

> For simplicity, this example presumes that all borrower rebates, agent fees, and lender's net earnings were fully paid at year-end.

Disclosures

Cash, investments, and securities lending

> The following shows only the schedule of investments by type and the disclosures required for securities lending. Other disclosures required by Statement 3, as amended, or Statement 40 also would be made in this note. Explanation of the valuation of the carrying amount of deposits and investments and the accounting policy for securities lending transactions would be in the summary of significant accounting policies.

Investments as of December 31, 2004, are as follows. (Amounts are in thousands.)

Investment Type	Fair Value
Repurchase agreements	$ 976,050
Commercial paper	59,200
U.S. government and agency securities	1,612,800
Domestic corporate fixed-income securities	840,000
Domestic equities	1,720,000
International equities	825,000
Securities lending short-term collateral investment pool	627,000
Mutual funds	122,000
Total	$6,782,050

Securities Lending Transactions. State statutes and board of trustees investment policies permit the system to use investments of the two plans to enter into securities lending transactions—loans of securities to broker-dealers and other entities for collateral with a simultaneous agreement to return the collateral for the same securities in the future. The system's securities custodians are agents in lending the plans' domestic securities for cash collateral of 102 percent and international securities for cash collateral of 105 percent. At year-end, the system has no credit risk exposure to borrowers because the amounts the system owes the borrowers exceed the amounts the borrowers owe the system. Contracts with the lending agents require them to indemnify the system if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent) or fail to pay the system for income distributions by the securities' issuers while the securities are on loan.

All securities loans can be terminated on demand by either the system or the borrower, although the average term of the loans is one week. In lending international securities, the term to maturity of the securities loans is matched with the term to maturity of the investment of the cash collateral by investing only in overnight repurchase agreements. Such matching existed at year-end. In lending domestic securities, cash collateral is invested in the lending agent's short-term investment pool, which at year-end has a weighted average maturity of twenty-eight days. The relationship between the maturities of the investment pool and the system's loans is affected by the maturities of the securities loans made by other entities that use the agent's pool, which the system cannot determine.

Custodial Credit Risk. Custodial credit risk is the risk that, in the event of the failure of the counterparty, the system will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. Consistent with the system's securities lending policy, $226,050,000 was held by the counterparty that was acting as the system's agent in securities lending transactions.

Example B: Note Disclosures for Securities Lending Transactions—Securities and Letters of Credit Received as Collateral

Assumptions

Under the authority of state statutes, a state government uses the trust department of one of its custodial banks to lend its U.S. government and agency securities. Collateral is either U.S. government or agency securities or irrevocable letters of credit issued by approved banks. The custodial bank and its affiliates are prohibited from issuing the letters of credit that collateralize the securities loans, but they may be borrowers of the underlying securities. The securities lending contracts do not allow the state to pledge or sell collateral securities unless the borrower defaults. At initiation of the loan, the value of the collateral, whether securities or letters of credit, has to be at least 102 percent of the value of the securities lent. The custodial bank trust department holds the collateral in a segregated account in the name of the state and marks the collateral and securities lent to market daily. If the value of the collateral is below 100 percent of the value of the securities lent, additional collateral has to be provided by the end of the next business day. No more than one-half of the fair value of the state's U.S. government and agency securities can be lent at one time.

Before the lending transactions, the state's portfolio is as shown in the following table. The state reports its investments at fair value. (Amounts are in thousands.)

Investment Type	Fair Value
Repurchase agreements	$ 510,000
Commercial paper	58,000
Bankers' acceptances	121,500
U.S. government and agency securities	2,820,700
Domestic corporate fixed-income securities	780,000
Domestic equities	1,570,000
Total	$5,860,200

The following represents the balances of the securities lending transactions at the balance sheet date, December 31, 2004. (Amounts are in thousands and are reported at fair value.)

Loan	Underlying U.S. Government and Agency Securities	Collateral Value	Type of Collateral	Is the Borrower the Custodial Bank or an Affiliate?	Accrued Loan Premium
1	$ 220,000	$ 221,000	Letter of credit	Yes	46
2	300,000	299,000	Securities	No	31
3	512,000	512,000	Securities	Yes	85
4	370,000	371,000	Securities	No	53
Total	$1,402,000	$1,403,000			

The state has total credit risk of $1,116,000 on loans 2 and 3 because the borrowers owe the state more than the state owes the borrowers. On loan 2, the borrower owes the state $300,031,000 (the fair value of the underlying securities plus the accrued loan premium), which is $1,031,000 more than the $299,000,000 the state owes the borrower (the fair value of the collateral securities). On loan 3, the borrower owes the state $512,085,000, which is $85,000 more than the $512,000,000 the state owes the borrower. Loans 1 and 4 do not expose the state to credit risk because the underlying securities plus accrued interest are less than collateral value. Credit risk is summarized as follows. (Amounts are in thousands and include accrued interest.)

Loan	Borrower Owes	State/Lender Owes	Net Exposure	Credit Risk
1	$220,500	$221,000	$ (500)	—
2	300,031	299,000	1,031	$1,031
3	512,085	512,000	85	85
4	370,860	371,000	(140)	—
Total credit risk				$1,116

There are no provisions for agent indemnification on the securities lending transactions. There were no significant violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior-period losses during the year.

With regard to custodial credit risk, the state's investment in commercial paper ($58,000,000) is held by the counterparty and is uninsured.

The borrower in loan 1 is the custodial bank or one of its affiliates. No custodial credit risk disclosure is required because an unaffiliated bank issues the letter of credit collateralizing the loan. No custodial credit risk disclosures are required for the securities underlying loan 3 because the custodian of the collateral securities is the custodian's trust department and holds the securities in the state's name, and the borrower is one of the bank's affiliates or the commercial department of the custodial bank. If the borrower was the custodian's trust department or if the custody of the collateral securities was with the bank's commercial department, the underlying securities would be included as a custodial credit risk disclosure because the collateral would be held by the counterparty.

Disclosures

Cash, investments, and securities lending

> The following shows only the schedule of investments by category and the disclosures required for securities lending. Other disclosures required by Statement 3, as amended, or Statement 40 also would be made in this note. Explanation of the valuation of the carrying amount of deposits and investments and the accounting policy for securities lending transactions would be in the summary of significant accounting policies.

Investments as of December 31, 2004, are as follows. (Amounts are in thousands.)

Investment Type	Fair Value
Repurchase agreements	$ 510,000
Commercial paper	58,000
Bankers' acceptances	121,500
U.S. government and agency securities	2,820,700
Domestic corporate fixed-income securities	780,000
Domestic equities	1,570,000
Total	$5,860,200

Securities Lending Transactions. Under the provisions of state statutes, the state lends securities to broker-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. One of the state's custodial banks manages the securities lending program and receives securities or irrevocable bank letters of credit as collateral. The collateral securities cannot be pledged or sold by the state unless the borrower defaults. Collateral securities and letters of credit are initially pledged at 102 percent of the fair value of the securities lent, and additional collateral has to be provided by the next business day if its value falls to less than 100 percent of the fair value of the securities lent. No more than 50 percent of the state's U.S. government and agency securities may be lent at one time.

At year-end, the state had $1,116,000 in credit risk exposure to borrowers because the amounts they owed the state exceeded the amounts the state owed them. Additional collateral was provided the next business day, eliminating this exposure.

Custodial Credit Risk. Custodial credit risk is the risk that, in the event of the failure of the counterparty, the state will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Consistent with the state's investment policy, the state's investment in commercial paper ($58,000,000) is held by the counterparty and is not insured.

Example C: Note Disclosures for Securities Lending Transactions—Cash and Securities Received as Collateral

Assumptions

A retirement system is authorized by state statutes and board of trustees policies to lend its investment securities. The lending is managed by the system's custodial bank. All loans can be terminated on demand by either the system or the borrowers, although the average term of loans is one week. The custodial bank and its affiliates are prohibited from borrowing the system's securities.

The agent lends the system's U.S. government and agency securities and domestic corporate fixed-income and equity securities for securities or cash collateral of 102 percent. The securities lending contracts do not allow the system to pledge or sell any collateral securities unless the borrower defaults. All securities loans can be terminated on demand by either the system or the borrower, although the average term of the loans is one week. Cash collateral is invested in the agent's collateral investment pool, which has share values based on the amortized cost of the pool's investments. At year-end, the pool has a weighted average term to maturity of twenty-eight days. There are no restrictions on the amount of securities that can be lent at one time or to one borrower.

Before the lending transactions and the investment of the cash collateral, the system's investments are as shown in the following table. Except for mutual funds, the system's agent holds investment securities in the system's name. The system's agent is not affiliated or related to investment brokers. Accordingly, the system is not exposed to custodial credit risk. Investments in mutual funds are not subject to custodial credit risk. (Amounts are in thousands.)

Investment Type	**Fair Value**
Mutual funds	$ 122,000
Repurchase agreements	750,000
Commercial paper	59,200
U.S. government and agency securities	1,612,800
Domestic corporate fixed-income securities	840,000
Domestic equities	2,545,000
Total	$5,929,000

The following represents the balances relating to the securities lending transactions at December 31, 2004. (Amounts are reported in thousands and at fair value.)

Securities Lent	**Underlying Securities**	**Securities Collateral Value**	**Cash Collateral Investment Value**
Lent for cash collateral:			
U.S. government and agency securities	$514,000	—	$525,000
Domestic corporate fixed-income securities	34,000	—	35,000
Domestic equities	65,000	—	67,000
Lent for securities collateral:			
Domestic equities	215,000	$220,000	—
Total	$828,000	$220,000	$627,000

The lending agent provides indemnification if the borrowers fail to return the underlying securities (and if the collateral is inadequate to replace the securities lent) or fails to pay income distributions on them. There were no significant violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior-period losses during the year. There are no income distributions owing on the securities lent.

For simplicity, this example presumes that all borrower rebates, agent fees, and lender's net earnings were fully paid at year-end.

Cash, investments, and securities lending

The following shows only the schedule of investments by category and the disclosures required for securities lending. Other disclosures required by Statement 3, as amended, or Statement 40 also would be made in this note. Explanation of the valuation of the carrying amount of deposits and investments and the accounting policy for securities lending transactions would be in the summary of significant accounting policies.

Investments as of December 31, 2004, are as follows. (Amounts are in thousands.)

	Fair Value
Repurchase agreements	$ 750,000
Commercial paper	59,200
U.S. government and agency securities	1,612,800
Domestic corporate fixed-income securities	840,000
Domestic equities	2,545,000
Securities lending short-term collateral investment pool	627,000
Mutual funds	122,000
Total	$6,556,000

Securities Lending Transactions. State statutes and board of trustees policies permit the system to lend its securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The system's custodian lends securities of the type on loan at year-end for collateral in the form of cash or other securities of 102 percent.

At year-end, the system has no credit risk exposure to borrowers because the amounts the system owes the borrowers exceed the amounts the borrowers owe the system. The contract with the system's custodian requires it to indemnify the system if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent) or fail to pay the system for income distributions by the securities' issuers while the securities are on loan.

All securities loans can be terminated on demand by either the system or the borrower, although the average term of the loans is one week. Cash collateral is invested in the lending agent's short-term investment pool, which at year-end has a weighted average maturity of twenty-eight days. The relationship between the maturities of the investment pool and the system's loans is affected by the maturities of the securities loans made by other entities that use the agent's pool, which the system cannot determine. The system cannot pledge or sell collateral securities received unless the borrower defaults.

Illustration 11

Aggregated PERS Deposit and Investment Disclosures

Assumptions

A public employee retirement system had uninsured and uncollateralized deposits and uninsured deposits with collateral held by the pledging bank's trust department not held in the system's name of $6,237,652 as of June 30, 2004. The system's investment policy limits custodial credit risk to 20 percent of the system's bank balance.

The system reports interest rate risk for its debt investments through separately identifying the interest rate risk associated with different maturity investments. The portfolio of short-term investments is limited to a weighted average maturity of less than nine months. The portfolio of long-term investments has an effective duration limitation of less than seven years. The system invests in interest-only tranches of collateralized mortgage obligations and variable-rate investments with coupon multipliers, investments that are considered to be highly sensitive to changes in interest rates.

Credit risk is limited by the system's investment policy to investments rated in the top two ratings by nationally recognized statistical rating organizations. Securities underlying repurchase agreements are in the form of U.S. Treasuries.

Disclosure

Custodial Credit Risk—Deposits. Custodial credit risk is the risk that in the event of a bank failure, the government's deposits may not be returned to it. The public employee retirement system (PERS) limits deposits subject to custodial credit risk to 20 percent of the system's bank balance. As of June 30, 2004, $6,237,652 of the system's bank balance of $37,658,654 was exposed to custodial credit risk as follows:

Uninsured and uncollateralized	$4,237,652
Uninsured and collateral held by pledging bank's trust department not in the system's name	2,000,000
Total	$6,237,652

Investments. As of June 30, 2004, the PERS had the following investments:

Short-term Debt Investments

Investment Type	Fair Value	Weighted Average Maturity (Years)
Repurchase agreements	$ 12,234,000	.05
Commercial paper	1,546,654	.53
Corporate bonds	1,648,652	.62
Total short-term investments	$ 15,429,306	
Short-term portfolio weighted average maturity		.16

Long-term Debt Investments

Investment Type	Fair Value	Effective Duration (Years)
U.S. Treasury	$138,650,458	5.28
U.S. agencies	12,564,945	4.28
U.S. government-sponsored enterprises	14,324,652	4.63
CMO interest-only tranches	20,000,000	12.63
CMO PAC tranches	12,324,246	.65
Total long-term investments	$197,864,301	
Long-term portfolio effective duration		5.62

Interest Rate Risk. Through its investment policies, the system manages its exposure to fair value losses arising from increasing interest rates. The system limits the weighted average maturity of its short-term investment portfolio to less than nine months, and limits the effective duration of its long-term investment portfolio to less than seven years.

Interest-Only Tranches. The PERS invests in interest-only tranches of collateralized mortgage obligations that are based on cash flows from interest payments on underlying mortgages. As of June 30, 2004, the fair value of these investments was $20 million. Interest-only tranches are sensitive to prepayments by mortgagees that may result from a decline in interest rates.

Variable rate investments with coupon multipliers. The system also holds variable-rate investments with coupon amounts that amplify the effects of interest rate changes by greater than a one-to-one basis. As of June 30, 2004, $5,346,932 of the system's government-sponsored enterprises position of $14,324,652 was invested in variable-rate investments with coupon multipliers ranging from 1.5 to 2.25 times the three-month London Interbank Offered Rate (LIBOR).

Credit risk. Consistent with state law, it is the system's policy to limit its debt investments to the top two ratings issued by nationally recognized statistical rating organizations. As of June 30, 2004, all of the system's investments in commercial paper are rated F-1 by Fitch Ratings, A1 by Standard & Poor's, and P-1 by Moody's Investors Service. Forty-five percent of the system's other debt investments were rated AAA by Fitch Ratings and Standard & Poor's, and Aaa by Moody's Investors Service. The remaining 55 percent of other debt investments were rated Aa by Moody's Investors and AA by Standard & Poor's and Fitch Ratings.

TOPICAL INDEX*

*Unless otherwise noted, the topics in this index are referenced to questions and answers.