**Definitions:**

GAAP—generally accepted accounting principles

GASB—Governmental Accounting Standards Board

Cash deposits—cash balances generally are any deposits in financial institutions that qualify for federal depository (FDIC) insurance

Custodial credit risk—the risk that, given a bank failure, the government will not be able to recover deposits or collateral

FDIC—Federal Deposit Insurance Corporation

LAMP—Louisiana Asset Management Pool

**Part 1.** Reporting Cash Balances

Governments are required to prepare their financial statements in accordance with generally accepted accounting principles (GAAP.) The use of GAAP ensures that each government's financial statements are accurate, consistent, and comparable to the way other governments are reporting.

Generally accepted accounting principles for governments are promulgated in statements issued by the Governmental Accounting Standards Board (GASB). GASB has recently issued its Statement Number 40, *Deposit and Investment Risk Disclosures,* which has changed the disclosure requirements for cash and investment balances. (The effective date of this statement is for financial statements for periods beginning after June 15, 2004.)

A government reports the amount of cash balances it has on it books at the end of the year as a component of its balance sheet in its audit, review/attestation, or compilation report. Each government determines which of its deposits in financial institutions are to be classified as cash, but cash balances generally are any deposits in financial institutions that qualify for federal depository (FDIC) insurance.

Additional information regarding a government's cash balances is disclosed in the notes to the financial statements. One of the required note disclosures concerns the risk that any of these balances is exposed to loss should the bank the government keeps its cash in fails. This is called *custodial credit risk*.

Louisiana Revised Statute 39:1225 requires each government to insure its cash balances from loss against custodial credit risk. A certain amount of a government's cash is insured from custodial credit risk through FDIC insurance. Often, however, a government's cash balances exceed the amount covered by FDIC insurance. When that occurs, state law requires that the government have an agreement with the bank for the bank to insure these excess balances from loss by pledging securities as collateral equal to or exceeding the amount of the excess balances. The bank may hold these securities themselves or give them to a third party to hold for them. If the bank fails, state law requires the financial institution holding these securities to advertise and sell the pledged securities within ten days of being notified by the government that the bank has failed to pay deposited funds upon request. As you can imagine, the least risk to a government's cash occurs when a third party holds the pledged securities.

A government's bank deposits are exposed to custodial credit risk if any of the three situations occurs:

- Deposits exceed FDIC insurance and pledged securities;
- Pledged securities are held by the government's bank; and/or
- Pledged securities are held by the government's bank's trust department or other agency, but not in the name of the government.

When deposits are exposed to custodial credit risk at the end of the period, a government must disclose the fact that balances are uninsured, the nature of the exposure (i.e., one of the three situations described above), and the amount exposed. The notes to the government's financial report must also disclose:

- Legal and contractual provisions governing cash deposits;
- Policies governing cash deposits;
- Defaults and recovery of prior-period losses; and
- Exposure to foreign currency risk (generally not applicable to Louisiana governments)

The notes to the financial statements should also disclose any legal restrictions governing cash deposits with financial institutions (such as insurance and collateralization requirements required by Louisiana state law), any material violations of these requirements during the fiscal year, and any actions the government has taken to address those violations. The notes should also disclose a government's policies concerning custodial credit risk. If a government does not have a policy concerning custodial credit risk, this fact must be disclosed.

There is usually a difference between the amount reported for cash balances on a government's financial statements and the amount on the government's bank statement at the same date, due to deposits in transit and outstanding checks. If the government with a June 30 fiscal year wrote a check for $100 on June 29 and the bank failed before the check cleared the bank, the government would have lost that $100 and would still owe the vendor that amount. Therefore, governments are required to report any bank balances that are subject to custodial credit risk at the end of the fiscal year.

**Part 2.** Reporting Investment Balances

A government reports the amount of investment balances it has on its books at the end of the year as a component of its balance sheet in its audit, review/attestation, or compilation report. Additional information regarding a government's investment balances is disclosed in the notes to the financial statements.

As stated in Part 1, cash balances generally are deposits in financial institutions that qualify for federal depository (FDIC) insurance. It would follow that deposits in financial institutions that do not qualify for FDIC insurance are generally classified as investments.

GAAP require the following types of disclosures regarding investments:

*Legal and contractual provisions governing investments, such as legal restrictions on the types of allowed investments*. Governments in Louisiana are restricted as to the types of instruments in which they are allowed to invest by state law (Louisiana Revised Statute 33:2955). In addition, Attorney General Opinion 92-192 allows governments to invest in LAMP. Any material violations of these and other requirements during the period must be disclosed, as well as actions the government has taken to address these violations.

*Investment policies concerning credit risk (including custodial credit risk, discussed in the following paragraph), concentration risk, interest rate risk, and foreign currency risk (discussed under the heading "Other credit risk exposure"), if the government is in fact exposed to one of these risks.* If a government is currently exposed to one of the above risks, and does not have a policy that addresses that risk, this fact must, itself, be disclosed. To qualify as an investment policy, a given item must either be formally adopted by the governing body or be incorporated into a contract.

*Exposure to custodial credit risk as of the date of the financial statements*. Custodial credit risk is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. Any investments that are both uninsured and unregistered are exposed to custodial credit risk in either of the following situations:

- Investments are held by the counterparty, or
- Investments are held by the counterparty's trust department or agent but not in the name of the government.

When a government has investments that are exposed to custodial credit risk at the end of the period, the government must disclose the type of investment, the reported amount, and how they are held. Although all bank deposits are potentially subject to custodial credit risk, investments are subject to custodial credit risk only if they are evidenced by securities that exist in physical or book entry form.

*Participation in external investment pools*. Governments must disclose their participation in external investment pools, such as LAMP. Governments with investments in external investment pools that are not registered with the Securities and Exchange Commission must also describe any regulatory oversight of the pool and state whether the fair value of the government's position in the pool is the same as the value of the pool shares. Because LAMP is not registered with the Securities and Exchange Commission, governments with investments in LAMP are required to make these additional disclosures.

*Information concerning realized gains and losses*. Although GAAP does not permit governments to distinguish between realized gains and losses (occur when an investment matures or is sold) from unrealized gains and losses (result from fluctuations in the fair value of an investment before it is sold or matures) on the face of the financial statements, governments may disclose information on realized gains and losses in the notes to the financial statements. If a government chooses to disclose realized gains and losses in the notes, the following additional information must accompany this disclosure:

- The calculation of realized gains and losses is independent of the calculation of the net change in the fair value of investments, and
- Realized gains and losses in the current year include unrealized gains and losses on those same investments that were recognized in previous periods as part of the net appreciation or depreciation in the fair value of investments.

*Defaults and recovery of prior-period losses*. A government that incurs a loss or recovery of a prior period loss as the result of a default on its investments should disclose this information in the notes, if it is not separately visible on the face of the financial statements.

*Other credit risk exposure*.

- The notes to the financial statements must disclose the credit ratings of all debt securities the government has at year-end. This disclosure does not apply to debt securities of the U.S. Government or obligations of U.S. Government agencies that are explicitly guaranteed by the U.S. Government [e.g., Government National Mortgage Association (GNMA) or Farmer's Home Administration (FHA)]. However, this disclosure must be made for obligations of U.S. Government instrumentalities, which are only implicitly guaranteed by the U.S. Government [e.g., Federal Home Loan Bank (FHLB) or Student Loan Marketing Association (SLMA)].
- A government that has 5 percent or more of its total investments in the securities of a single issuer is exposed to *concentration risk*, and must disclose this in the notes to the financial statements. This disclosure does not apply to concentrations of U.S. Government obligations and obligations explicitly guaranteed by the U.S. Government, due to the minimal risk associated with these types of investments.
- If the government has debt securities, these investments may be subject to *interest rate risk*, which is the risk that potential purchasers of debt securities will not agree to pay face value for those securities if interest rates subsequently increase. Direct or indirect holders of debt securities must use one of five specified methods to disclose interest rate risk.
- If a government holds investments denominated in a currency other than the U.S. dollar, it exposes itself to risks associated with currency fluctuation or *foreign currency risk*. It must disclose the value of such investments in U.S. dollars.

Additional disclosures are required for governments that have entered into interest rate swap agreements in association with debt they have issued.

If you have questions, you may contact Suzanne Elliott of the Legislative Auditor's Office at (225) 339-3802 or selliott@lla.state.la.us.

Sources: GASB Statement 40