GASB Statement 53 – The Basics

- GASB 53 addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments.

- Common types of derivative instruments used by governments include:
  – Interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts.

- GASB 53 requires governments to report most of their derivatives at <u>fair value</u> on their statement of net assets. Depending on their value, derivatives may be reported as assets or liabilities.
  – The presumed fair value of a derivative is its market price. In the absence of an active market, a government may use the discounted value of expected cash flows to measure fair value or it may use formula-based or mathematical models.

- Changes in the fair value of <u>investment derivative instruments</u> should be reported as investment income in the period in which they occur.
  – Investment derivative instruments are derivatives that are entered into by the government primarily for the purpose of obtaining income or profit, or derivatives that the government determines are ineffective as hedges.

- Changes in the fair value of <u>hedging derivative instruments</u> should be deferred until a termination event occurs (e.g., the hedge is determined to be ineffective or the hedged asset or liability is sold or retired).
  – Hedging derivative instruments are derivatives that significantly reduce an identified financial risk by substantially offsetting changes in cash flows or fair values associated with items not reported at fair value.

- Hedging derivative instruments must meet annual effectiveness tests.
  – Once a hedging derivative is determined to be ineffective, any related deferred amounts should be closed to investment income.
  – <u>Exception</u> – For refundings, the deferral amount should be treated as an adjustment to the net carrying amount of the old debt.

- The note disclosure requirements of GASB 53 reflect the pronouncements distinction between derivatives that function as investments and derivatives used for hedging.
  – Like other investments, derivatives that function as investments generally must provide the disclosures mandated by GASB Statement No. 40.
  – For other derivatives involving hedges, GASB 53 has essentially incorporated the disclosure requirements of GASB Technical Bulletin 2003-1.
  – A note disclosure that includes summary information about a government's derivative instruments is also required by GASB 53.

- Additional resources:
  – A plain language summary of GASB 53 is available for download on the GASB website (http://www.gasb.org/project_pages/derivatives.html)
  – A GASB 53 implementation guide was issued in February 2009 (available for purchase)

Key Implementation Issues

- Determine if your agency has any derivative instruments that will need to be reported as either assets or liabilities in the basic financial statements for fiscal year 2009-10.

- Determine if beginning fund equity will need to be restated for derivatives existing prior to July 1, 2009. The transition requirements of GASB 53 are as follows:

  – Evaluate the effectiveness of existing potential hedging derivatives as of the end of the current reporting period (i.e., June 30, 2010).
    - If determined to be effective, the derivative instrument should be reported as a hedging derivative instrument as if it was effective from its inception (i.e., no restatement necessary for the cumulative change in fair value).
    - If determined to be ineffective, the derivative instrument should be evaluated as of the end of the previous reporting period (i.e., June 30, 2009).
      - If found to be effective at that date, the agency should report a termination event in the current period (i.e., 2009-10 fiscal year, no restatement necessary).
      - If found to be ineffective at that date, the agency should report the transaction retroactively as if it were an investment derivative transaction (i.e., restate beginning fund equity).

- Agencies are required to assess the effectiveness of potential hedging derivative instruments at the end of each reporting period. Effectiveness is determined by considering whether the changes in cash flows or fair values of the potential hedging derivative instrument substantially offset the changes in cash flows or fair values of the hedgeable item.

  – GASB 53 lists 4 methods that may be used to assess hedge effectiveness (i.e., the consistent critical terms method and 3 quantitative methods. Who will perform this assessment (e.g., your agency or a third-party)?

  – First reporting period evaluation. If a potential hedging derivative instrument is first evaluated using the consistent critical terms method and is found to be ineffective, at least one quantitative method should also be applied before concluding that the potential hedging derivative instrument is ineffective. An agency, may but is not required to, apply other quantitative methods before concluding that the potential hedging derivative instrument is ineffective. Once an instrument is determined to be ineffective, it should not be evaluated for effectiveness in subsequent reporting periods for financial reporting purposes.

  – Evaluation in subsequent reporting periods. All potential hedging derivative instruments that were evaluated and determined to be hedging derivative instruments in the prior reporting period should be re-evaluated as of the end of the current period using the method that was previously applied. If found to be no longer effective, other methods, may, but are not required to, be applied before concluding that the hedging derivative is no longer effective.

- All derivatives included in the scope of GASB 53 are required to be reported at their fair value, with the exception of fully benefit-responsive synthetic guaranteed investment contracts.

  – Fair value is the market price of a derivative if there is an active market for the instrument. When market price is not available, agencies may estimate fair value by forecasting expected future cash flows (must be discounted). Formula-based methods and mathematical methods are also acceptable for determining fair values.

  – Fair values developed by pricing services are acceptable, provided that those values are developed using the methods described in paragraph 21 of GASB 53.

  – For future derivatives, may want to require counterparties to provide fair values, at least annually, in accordance with GASB 53.

  – How will fair values be determined?