Bobby Jindal
Governor

Angele Davis
Commissioner of Administration

State of Louisiana

Division of Administration

Office of Statewide Reporting and Accounting Policy

April 21, 2010

OSRAP MEMORANDUM 10-18

TO: Fiscal Officers
All State Entities

FROM: Afranie Adomako, CPA
Director

SUBJECT: Implementation of Governmental Accounting Standards Board (GASB) Statement 53, *Accounting and Financial Reporting for Derivative Instruments* (Effective FY 2010)

In June 2008, GASB issued Statement 53, *Accounting and Financial Reporting for Derivative Instruments*. For derivative instruments within the scope of this statement, GASB Statement 53 requires governments to (1) measure and present derivative instruments at fair market value in the Statement of Net Assets (with the exception of Synthetic Guaranteed Investment Contracts [SGICs] that are fully benefit-responsive), (2) recognize changes in fair market value in the reporting period to which they relate, (3) report changes in fair market value of hedged derivative instruments as either a deferred inflow of resources or a deferred outflow of resources on the Statement of Net Assets, (4) report changes in fair market value of investment derivative instruments as part of investment revenue in the current reporting period, and (5) disclose specific relevant information for the derivative instruments. Implementation of this Statement is required for periods beginning after June 15, 2009, or effective for fiscal year 2010 and includes Comprehensive Annual Financial Report (CAFR) entities with a fiscal year end date of/or after October 31, 2009.

GASB Statement 53 applies to all state and local government entities, including general-purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. <u>If your entity does not invest in derivatives or enter into derivative agreements, then this memo will serve as information only.</u> The scope of this Statement excludes the following financial instruments:

- Derivatives instruments that are normal purchases and normal sales contracts;
- Insurance contracts accounted for under GASB 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*
- Certain financial guarantee contracts;

- Certain contracts that are not exchange traded; and
- Loan commitments

Derivative instruments are often complex financial arrangements used by governments to manage specific risks or to make investments. By entering into these arrangements, governments receive and make payments based on market prices without actually entering into the related financial or commodity transaction. Some common derivative instruments used by governments include interest rate swaps, commodity swaps, interest rate locks, options, swaptions, forward contracts, and future contracts. A derivative instrument has **all** of the following characteristics:

(1) Settlement Factors - It has one or more reference rates and one or more notional amounts, or payment provisions for both.

(2) Leverage - It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(3) Net Settlement – Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Effective Derivative Instruments:
A derivative instrument is considered hedged if it is associated with a hedgeable item and if it is determined to be effective in significantly reducing the identified financial risks. Generally, effectiveness is determined by considering whether the changes in cash flows or fair market values of the potential hedged derivative instrument substantially offset the changes in cash flows or fair market values of the hedged item. Hedged accounting should be applied to these hedged derivative instruments.

GASB Statement 53 sets forth four evaluation methods for determining effectiveness:

1. Consistent Critical Terms Method – This method evaluates effectiveness by qualitative consideration of the critical terms of the hedgeable item and the potential hedging derivative instrument.

2. Synthetic Instrument Method – This quantitative method evaluates effectiveness by combining the hedgeable item and the potential hedging derivative instrument to simulate a third synthetic instrument.

3. Dollar-Offset Method – This quantitative method evaluates effectiveness by comparing the changes in expected cash flows or fair values of the potential hedging derivative instrument with the changes in expected cash flows or fair values of the hedgeable item.

4. Regression Analysis Method – This quantitative method evaluates effectiveness by considering the statistical relationship between the cash flows or fair values of the potential hedging derivative instrument and the hedgeable item.

In hedge accounting, the change in the fair market value of hedged derivative instruments are reported as either deferred inflows or deferred outflows in the government's Statement of Net Assets. In most cases, when the derivative is no longer effective, the accumulated changes in the fair market value shall be reported within investment revenue, as either an increase or decrease, on the Income Statement or Statement of Revenue, Expenditures, and Changes in Net Assets.

Required footnote disclosure of hedged derivative instruments include:

- the objectives of the hedged derivative instrument,
- the terms of the hedged derivative instrument,
- the risks of the hedged derivative instrument,
- the hedging derivative instrument's net cash flows, if the hedged item is a debt obligation, and
- other quantitative method of evaluating effectiveness, if applicable

Ineffective Derivative Instruments:
In the event that a potential hedged derivative instrument is determined to be ineffective, the derivative instrument is defined as held as an investment; and the change in fair market value should be reported in investment revenue on the Income Statement or Statement of Revenue, Expenditures, and Changes in Net Assets. The footnote disclosures for investment derivative instruments are similar to the disclosure requirements for other investments.

Implementation of GASB Statement 53:
The evaluation of effectiveness of potential hedged derivative instruments existing prior to fiscal year end should be performed as of the end of the current fiscal year (FYE 2010). If the potential hedged derivative instrument is deemed to be effective, the hedged derivative instrument is reported as if it was effective from the date of its inception using hedge accounting. If the potential hedged derivative instrument is deemed to be ineffective, then it is re-evaluated as of the end of the prior reporting period (FYE 2009).

Each affected entity will need the following information from fiscal year ending June 30, 2009 for each potential hedged derivative instrument:

1. the associated historical cost and fair market value of those potential hedged derivative instruments,

2. the accumulated change in fair market value of those potential hedged derivative instruments since their inception,

3. the date of inception, the objectives, terms, and risks of those potential hedged derivative instruments, and

4. a summary of the potential hedged derivative instrument activity that provides an indication of the location of the fair market value amounts reported on the financial statements.

According to GASB 53, paragraph 80, "Accounting changes adopted to conform to the provisions of this Statement should be applied retroactively by restating the financial statement, if practical, for all prior periods presented. If retroactive application is not practical, the cumulative effect of applying this Statement, if any, should be reported as a restatement of beginning net assets, fund balance, or fund net assets, as appropriate, of the earliest period restated. In the period this Statement is first applied, the financial statement should disclose the nature of any restatement and its effect. Also, the reason for not restating prior periods presented should be explained."

GASB Statement 53 supersedes Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*. OSRAP will request the derivative disclosures in the applicable Annual Fiscal Report (AFR) packets (i.e., the discrete component unit AFR packets, the business-type activities AFR packets, and some of the specialty AFR packets). You may contact me at (225) 342-0708 or Ms. Marella Allatto Houghton at (225) 219-4445 or via email at Marella.Allatto@la.gov with any questions regarding GASB Statement 53.

AA:mh