



*GASB 53, Accounting and Financial Reporting for
Derivative Instruments (“GASB 53”) Technical Update
Understanding The Sleeping Giant*

Deloitte & Touche LLP

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GASB 53 Technical Update



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Why?

- Establish a comprehensive framework for measurement, recognition & disclosure of derivative transactions in order to enhance the usefulness and comparability of derivative instrument activity reported

Effective date

- Effective for fiscal years beginning after June 15, 2009 (early application encouraged) and applicable for all state and local governments that enter into derivative instruments



Definition of Derivative Instrument

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A derivative instrument is a financial instrument or other contract that has all of the following characteristics:

a. Settlement factors

- This includes one or more reference rates and one or more notional amounts or payment provisions (or both)

b. Leverage

- It requires no or little initial net investment

c. Net settlement

- Financial net settlement, market mechanism, or readily convertible to cash

Examples

- Interest rate swaps, FX forward contracts, options, futures contracts, commodity purchase/sale agreements, etc.

Watch out for:

- Hybrid instruments (companion host plus embedded derivative)
- Fully benefit-responsive Synthetic Guaranteed Investment Contracts (“SGICs”) (combination of underlying investments and wrap contract)



Scope Exceptions

1. Normal purchases and normal sales contracts – certain derivative purchase/sales contracts are excluded from the scope of GASB 53 provided the government takes or makes delivery of the commodity specified in the contract. Below are a few indicators of a normal purchase, normal sales contract:

- The government has entered into such a contract in the past (provides history)
- The government has a practice of taking delivery or selling the commodity
- The quantity of the commodity in the contract is consistent with the volume used in the government's activities
- Evaluation whether the contract meets the requirements for normal purchase and normal sales scope exception should be conducted as often as financial statements are prepared i.e. on a yearly basis.

Example – a government's natural gas utility enters into a contract to purchase natural gas from a regional transportation pipeline. Settlement provisions of the contract permit the utility to take delivery of the gas or to pay or receive a settlement price. This government routinely enters into similar contracts and takes delivery of the gas. The volume of gas specified in the contract is consistent with the volume expected to be sold to its customers for this time period. This contract is a normal purchase contract and, therefore, is outside the scope of GASB 53.



Scope Exceptions (Cont'd)

2. Insurance contracts – contracts accounted for under GASB 10 are scoped out from this statement if it entitles the holder to be compensated only if as a result of an identifiable insurable event (other than change in price (variable)).
3. Financial guarantee contracts – contracts which provide for payments to the holder if a debtor fails to make payment are scoped out
 - If the financial guarantee provides payments in response to changes in a reference rate, the contract is within the scope of GASB 53 if it meets the definition of a derivative (e.g. financial guarantee contract requiring payments made if credit rating of debtor falls below AA)
 - A credit default swap between the counterparty and government, with the city's bondholders being the beneficiaries should not be reported as a derivative by government within its financial statements
4. Non exchange-traded contracts – these contracts are scoped out if it is non exchange-traded and the reference rate is based on:
 - Climatic, geological, or other physical variable (e.g. payment made if temperature increases by 10 degrees or if a hurricane occurs), or
 - Price or value of a non-financial asset (e.g. contract for the purchase of a fleet of vehicles and the liquidated damages if either party fails to perform is based on a percentage of the value of the vehicles, which is a non-financial asset)
 - Variable payment based on commodity index (for e.g. West Texas Intermediate petroleum) is not considered a climatic or geological variable, hence, the contract does not qualify for scope exception
5. Loan commitments – some governments extend loan commitments (e.g., for first-time home buyers). Such commitments are excluded from the statement



Classification of Derivatives

- Derivative instruments fall under two broad categories:
 - Investment derivative instrument – a derivative instrument that is entered primarily for the purpose of obtaining income or profit, or a derivative instrument that does not meet the criteria of a hedging derivative instrument
 - Hedging derivative instrument – a derivative instrument that is associated with a hedgeable item and significantly reduces an identified financial risk by substantially offsetting changes in cash flows or fair values of the hedgeable item
 - A potential hedging instrument that meets the hedge effectiveness criteria should be reported using the hedge accounting guidance
 - Exchange traded derivative instruments should be accounted for based on the trade date.
 - Utilities should test potential derivative instruments for effectiveness and, if found to be effective, apply hedge accounting even if the government utility is subject to FAS 71 deferral accounting
- NOTE: If an instrument's purpose is to reduce a governmental entity's risk, it is **required** to be classified as a hedging derivative instrument assuming it meets the criteria outlined in GASB 53 (discussed later)



Reporting Derivative Activity

- Derivative instruments should be:
 - Measured at fair value, except for the measurement of fully benefit-responsive SGICs
 - Reported on statement of net assets, with classification depending whether they represent assets or liabilities
 - If the derivative instrument meets the requirements of a hedging derivative instrument and thus was a part of an effective hedging relationship, the payment provided by the hedging derivative instrument should be reported as an adjustment of the actual transaction
- Presentation of changes in fair value (FV) depends on whether the derivative is an investment derivative or a hedging derivative
 - Investment derivative instruments: reported within investment revenue classification on the flow of resources statement
 - Hedging derivative instrument: reported either as deferred inflows or deferred outflows in the statement of net assets
 - The entire change in fair value of an effective hedge instrument receives hedge accounting treatment (not just the effective portion)
 - Contemporaneous documentation of the hedging relationship is **not** a requirement of GASB 53
 - A government utility applies FAS 71. The utility should test potential hedging derivative instruments for effectiveness and, if found to be effective, apply hedge accounting



Evaluation of Effectiveness

Evaluation of Effectiveness

- Potential hedging derivative instruments should be evaluated for effectiveness as of the end of each reporting period
- Evaluation of effectiveness of all potential hedges should be evaluated by considering overall changes in fair value or cash flows of the potential hedging derivative instrument
- Separation of the total value into time value or interest is permissible for some potential hedges that meet certain criteria

Methods to Evaluate Effectiveness

- Consistent critical terms method (qualitative assessment method)
- Quantitative methods
 - Synthetic instrument method
 - Dollar-offset method
 - Regression analysis method
 - Other quantitative method

Note: GASB 53 only requires an assessment of effectiveness; there is no requirement to measure the amount of ineffectiveness that may exist as the entire value of a hedging instrument is treated as a hedge, regardless of any true ineffectiveness



Disclosure Requirements

Notes to Financial Statements

- Derivatives activity should be divided into hedging derivative instrument (distinguish between cash flow and fair value hedges) and investment derivative instruments.
- Disclosure should include notional amount, changes in FV during the reporting period and classification where those changes are reported, FV at the end of reporting period and its classification in FS.
- If FV is based on other than quoted market prices; the methods and significant assumptions used to estimate the FV and FV of derivative instruments reclassified from a hedging derivative instrument to an investment derivative instrument as well as the deferral amount that was reported within investment revenue upon reclassification
- Disclosures for all hedging activity includes the objective, term, risk (credit risk, interest rate, basis, rollover, hedged debt, market access and FX risk), hedged debt and other quantitative methods of evaluating effectiveness



Effective Date and Transition

- The requirements of this statement are effective for periods beginning after June 15, 2009; earlier adoption is encouraged
- If practical, retroactive application by restating financial statements for all reported periods should be made
- If not practical, the cumulative effect of applying the statement should be reported as a restatement of beginning net assets, fund balance or fund assets for the earliest period restated
- For derivatives existing prior to implementation, evaluation of effectiveness should be performed as of the end of current reporting period
- If effective, derivative instrument should be reported as hedging derivative instrument from inception
- If ineffective, evaluation should be performed as of the end of previous period
- If effective at the end of previous reporting period, provisions of GASB 53 paragraph 23 apply (terminated hedge)
- If ineffective at end of previous reporting period, then is treated purely as an “investment” derivative and transition follows the provisions of GASB 53 paragraph 8

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Broad Impacts and Initial Readiness

Why It Matters to Airport Authorities

Broad impacts

GASB 53 affects numerous and far-reaching areas of acute interest to various entities. This scope is likely not fully appreciated by many entities. Affected areas include, but not limited to, derivatives instruments (accounting and valuation), normal purchase/sale commodity contracts, insurance contracts, certain financial guarantee contracts.

Policy implications

The standard introduces accounting concepts (deferral of changes in FV of effective financial instruments, scope exception of certain contracts). Each of these areas require new policy decisions by the entity to be documented as part of Risk Management and Derivative Accounting Policy.

Cross functional teaming

The scope of the standard includes reporting and accounting of financial derivative instruments, non-financial physical supply agreements, insurance and debt agreements. Teaming across various functions (e.g., treasury, information technology, purchase/procurement department) becomes imperative for successful transitioning and implementation of the standard.

Effects on FS geography

Changes in fair value of hedging derivative instruments are reported as either deferred inflows or deferred outflows in the statement of net assets. Changes in fair values of investment or ineffective derivative instruments should be reported within the investment revenue on the flow of resources statement.

Pervasive systems issues

Current systems may be inadequate for valuation and to determine if the derivative instrument is effective or not, inadequate systems to capture required data inputs and inventorying of various financial and physical derivative contracts. Raises tough questions around offline updates and related internal controls considerations.

Immediate Readiness Considerations

Project Management

One of the most critical components is to set up the right Project Management team to ensure smooth transition to GASB 53. This team should have representation from the following broad functions of an entity:

- Treasury
- Accounting
- Information Technology
- Involvement of auditors

Data gathering / Inventory

Perform robust data-gathering in terms of inventory of all financial derivative instruments, long term supply contracts for various commodities, insurance agreements, financial guarantee contracts, debt agreements etc. to ensure adequate analysis is performed to each contracts (or category of contracts) for appropriate accounting under the standard.

Readiness questionnaire

As a readiness effort, entities should attempt to answer a few generic questions to get a better handle on the derivative activities, these questions are:

- Does the entity have a risk management and derivative accounting policy?
- Is there an adequate system to capture all derivatives?
- What various economic exposures does the entity have i.e. FX, interest rate, commodity
- What asset/liability/forecasted transaction is being hedged?
- Is there a method followed by the entity to evaluate if these instruments are good hedges?
- How significant is the derivative activity?
- Does entity have in-house capabilities for valuation?
- Does the entity have physical supply contracts for commodities like natural gas, power, etc.?
- If so, have they been assessed to determine if they are derivatives that qualify for the Normal scope exception?
- Is there historic data available to determine the entities activities with respect to these contracts?

Training

Entities should consider technical training given the nature of standard to ensure that all personnel affected by GASB 53 understand the requirements of the standard. This in turn will ensure appropriate accounting and reporting of derivative instruments.



How Deloitte can Help

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Deloitte's AVA Practice

- The Accounting, Valuation & Analytics (AVA) practice of Deloitte consists of approximately 450 national professionals and is our firm's center of excellence for financial instruments.
- We initially implemented FASB 133, *Accounting for Derivative Instruments and Hedging Activities* ("FASB 133") for numerous companies and have worked extensively with clients since its inception including recently assisting companies in improvement projects for their hedging strategies and overall hedge accounting for various markets including commodities, foreign currencies and interest rates.
- Experience in assisting clients with their IFRS conversion efforts related to IAS 39, *Financial Instruments: Recognition and Measurement* ("IAS 39") by leveraging our FAS 33 skills, but at the same time, appreciating key differences to assess financial statement impact upon conversion.
- Our professionals have experience in dealing with issues related to valuation techniques for financial instruments, securities, commodities, and other investment products; pricing models; forward curve development methodologies; and cash flow modeling.
- We also have extensive experience in assessing and developing internal control policies and procedures for financial and operational processes related to derivative transactions.
- Assist clients in identifying functional requirements and teaming with "off the shelf" software providers with customization solutions to meet specific client requirements.

Accounting, Valuation & Analytics Group

One Stop Shop for

Accounting Implementation

Valuation Assistance

IT infrastructure setup

Assessment of Internal Controls

Industries Served

Consumer Products

Energy

Technology

Banking

Transportation

Securities/IB

Real Estate

Health Care

Manufacturing

GASB 53 Implementation Plan

Phase I – Assessment of GASB 53 Impact

- Gain an understanding of current derivative processes and policies
- Assess the potential GASB 53 financial statement impact
- Identify potential project resources and current system capabilities

Phase II – Develop Implementation Plan

- Analyze derivatives as effective hedging instruments or otherwise
- Assess non-financial contracts to determine if excluded from scope of GASB 53
- Search for embedded features
- Draft risk management and accounting policies
- Assess adequacy of disclosures, systems, internal control and valuation methodologies

Phase III – Detailed Implementation

- Update and implement policies and internal control processes
- Assist in adopting the financial statement impact of GASB 53 including analyzing the potential restatement impact
- Customize/modify software/system in partnership with vendor and valuation methodologies as needed

The three phases will encompass the following areas:

- Accounting for derivative instruments as hedges or investments
- Valuation of derivative instruments
- Accounting of non financial contracts
- Accounting for hybrid contracts
- Disclosures framework under GASB 53

Recent Activities

- GASB issued an implementation guide for GASB 53 in June 2009 which clarified certain interpretive issues of this standard (some of these interpretive issues are included within this slide deck)
- GASB issued a “plain language summary of GASB 53, which can be accessed at http://www.gasb.org/plain-language_documents/index.html

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