

Kansas GFOA GASB Update

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Objectives

Effective now:

- GASB 55: Hierarchy of GAAP for State / Local Gov'ts
- GASB 56: Codification of Guidance in Audit Standards

For years ending June 30, 2009 and after:

- GASB 52: Land and Other Real Estate Held as Investments by Endowments

For years ending June 30, 2010 and after:

- GASB 51: Intangible Assets
- GASB 53: Derivatives

For years ending June 30, 2011 and after:

- GASB 54: Fund Balance

GASB 55: Hierarchy of GAAP for State & Local Governments

Descending order of authority:

- GASB Statements and Interpretations
- GASB Technical Bulletins, AICPA Industry Audit & Accounting Guides and Statements of Position (if made applicable to gov'ts)
- AICPA Practice Bulletins (if made applicable to gov'ts)
- Implementation Guides published by the GASB staff and practices that are widely recognized and prevalent

GASB 56: Codification of Guidance Contained in the AICPA Statements on Auditing Standards

Related-party transactions:

- Should recognize the substance of the transaction over its legal form
- Disclose

Subsequent events:

- Recognized events require adjustments
- Nonrecognized events – may be disclosed

Going concern considerations: evaluate for 12 months beyond the financial statement date.

GASB 52: Land & Real Estate Held for Investment by Endowments

Effective with June 30, 2009 year-ends

- Endowments must report land and other real estate held for investment at fair value
- Change in fair value to be reported as investment income
- Disclose methods and assumptions used to determine fair value

GASB 51

Intangible Assets

GASB 51: Accounting and Financial Reporting for Intangible Assets

An intangible asset must have ALL of the following:

- Lack of physical substance
- Non-financial in nature
- Initial useful life extending beyond a single reporting period

Common intangible assets

Right-of-way easements

Other easements

Patents, copyrights, trademarks

Land use rights

Licenses and permits

Computer software

- purchased or licensed
- internally generated

Accounting for intangible assets

- All intangible assets should be classified as capital assets.
- Means that other authoritative guidance related to capital assets also applies (recognition, measurement, depreciation, impairment, presentation, etc.)
 - Therefore not reported as assets in the governmental funds

Recognition of intangible assets

An intangible asset should be recognized only if it is identifiable:

- Asset is separable (capable of being separated or divided from the gov't and sold, transferred, licensed, rented, etc.)

OR

- Asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable

Measurement

Follow same guidance as for capital assets:

- Historical cost
- If donated, estimated fair value at date of donation

Donated right-of-way easements for roadways

Fair value = amount for which the asset could be exchanged in a current transaction between willing parties

Easements: generally the only willing buyer is the government. Therefore, the amount which the gov't would have incurred to acquire the easement can be used for fair value.

- can use the fair value of the associated land

Internally generated intangible assets

Considered an internally generated asset (IGA) if:

- Created or produced by the government or an entity contracted by the government
- Acquired from a third party, but requires more than minimal incremental effort on the part of the government to achieve expected service capacity

IGAs – when to capitalize

Only if ALL of the following occur:

- 1) Determination of the specific objective of the project and service capacity expected
- 2) Demonstration of the technical or technological feasibility for completing the project
- 3) Demonstration of the current intention, ability, and presence of effort to complete or continue development

Internally generated computer software

Either:

Developed in-house by the government's personnel, or

Commercially available software modified using more than minimal incremental effort before being put into operation

Software development stages

- 1) Preliminary project stage
- 2) Application development stage
- 3) Post-implementation / operation stage

Preliminary project stage

- Conceptual formulation and evaluation of alternatives
- Determination of the existence of needed technology
- Final selection of alternatives

Application development stage

- Design of the chosen path
- Coding
- Software configuration and interfaces
- Installation to hardware
- Testing, including parallel processing
- Data conversion, if necessary to make operational

Post-implementation / operation stage

- Application training
- Software maintenance
- Data conversion, if not necessary to make operational

Software – reporting activities

- Preliminary project stage – expense as incurred
- Application development stage – capitalize once criteria on slide 14 are met
- Post-implementation / operation stage – expense as incurred

Modifications to software

Outlays associated with modifications to software already in operation should be capitalized according to the previous guidance if it results in:

- 1) An increase in the functionality
- 2) An increase in the efficiency
- 3) An extension of the estimated useful life

Amortization

- Useful life taken from the term of contractual or other legal rights
- Indefinite useful life: no factors limiting the useful life
 - Example: permanent right-of-way easements

Impairment

Impairment analysis would be the same as under GASB 42, with one new additional item added:

- Development stoppage

Note disclosures

- No note disclosure requirements specific to intangible assets
- Intangible assets should be incorporated into the capital asset note disclosures

Effective date / transition

- Effective for periods beginning after June 15, 2009
- Generally applied retroactively (restating prior financial statements)
- Exceptions to retroactive reporting:
 - Not required for intangible assets with indefinite lives
 - Not required for internally generated assets (including those already under development)
 - Phase 1 & 2 gov'ts: only have to report assets acquired in fiscal years ending after June 30, 1980
 - Phase 3 gov'ts: retroactive reporting not required

Other examples

- 1) Land use rights: for those associated with property already owned, should not report as a separate intangible asset
- 2) Water rights: if acquired by a utility enterprise fund with the intent they be used in operations as the main source for water sold by the utility, they are a separable intangible asset
- 3) Websites: considered computer software

Other examples

- 4) Maintenance contracts: annual fixed fees for maintenance and upgrades – for upgrades, follow guidance on slide 21. Also may have an internal capitalization threshold policy which these may fall under.
- 5) Licensing agreement for computer software: for use of the software, routine systems maintenance, rights to future upgrades, etc. Allocate costs – i.e., if related to use of the software, capitalize; if for maintenance, expense

GASB 53

Derivatives

GASB 53: Accounting and Financial Reporting for Derivative Instruments

Why issued?

FASB Statement 133 did not take into account the government environment:

- Most government debt is tax exempt.
- Most government hedges are cash-flow hedges.
- Government model does not have an other comprehensive income category.

Basic questions

- Is the financial instrument or contract a derivative instrument?
- What risks are associated with derivatives?
- How should derivatives be accounted for?
- Does the derivative qualify as a hedge?
- When does the hedge terminate?
- What note disclosures are required?

What is a derivative instrument?

A financial instrument or contract that has ALL of the following characteristics:

- 1) One or more reference rates (underlyings) and one or more notional amounts or payment provisions
- 2) Leverage
- 3) Net settlement

Reference rates

- Security price or security price index
 - LIBOR – London Interbank Offered Rate
 - SIFMA Swap Index – Securities Industry and Financial Markets Association (formerly BMA rates)
 - MMD AAA General Obligations Index – Municipal Market Data (Thompson Reuters)
- Commodity price or price index
- Interest rate or rate index
- Credit rating or credit index
- Exchange rate or rate index

Notional amounts or payment amounts

Those terms determine the amount of the settlement, and in some cases, whether or not a settlement is required

- Examples of notional amounts:
 - Currency units
 - Commodity quantities (gallons, pounds)
- Examples of payment amounts:
 - Amount above a cap or below a floor

Leverage

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

Net settlement

Terms require or permit net settlement:

- Can readily be settled net by means outside the contract, or
- Provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement

How is a derivative different from a traditional financial instrument?

Investment instruments: generally do not meet the second characteristic (initial investment is not leveraged)

Debt instruments: generally do not meet the third characteristic (not net settled)

Excluded instruments

- Normal purchases and sales contracts (though the contract can be a derivative)
 - Commodity – gas, electricity
 - Gov't intends to and has practice of taking delivery or selling the commodity
 - Quantity is consistent with the volume used
- Traditional insurance contracts

Common derivative instruments

- Futures contracts
- Some forward contracts, including swaps
- Options – exchange-traded and others
- Interest-rate locks

What are the risks?

- Credit risk
- Interest-rate risk
- Basis risk
- Termination risk
- Rollover risk
- Market-access risk
- Foreign-currency risk

Accounting for derivatives

- Derivatives are measured on the statement of net assets at fair value
- Changes in fair value are reported on the income statement as investment income
- **EXCEPTION: HEDGES**
 - Changes in fair value are reported on the balance sheet as deferrals – either as deferred charges (assets) or deferred credits (liabilities)
 - Swap asset: deferred inflow of resources
 - Swap liability: deferred outflow of resources

When does a derivative qualify as a hedge?

Two requirements:

- 1) Association. The derivative is associated with a hedgeable item
- 2) Substantial offsets. The derivative is effective in providing changes in cash flows or fair values that substantially offset the cash flow or fair value changes of the hedgable item

Differences from FAS 133:

- If the above are met, hedge accounting is **REQUIRED**.
- Accounting is not dependent on documentation.

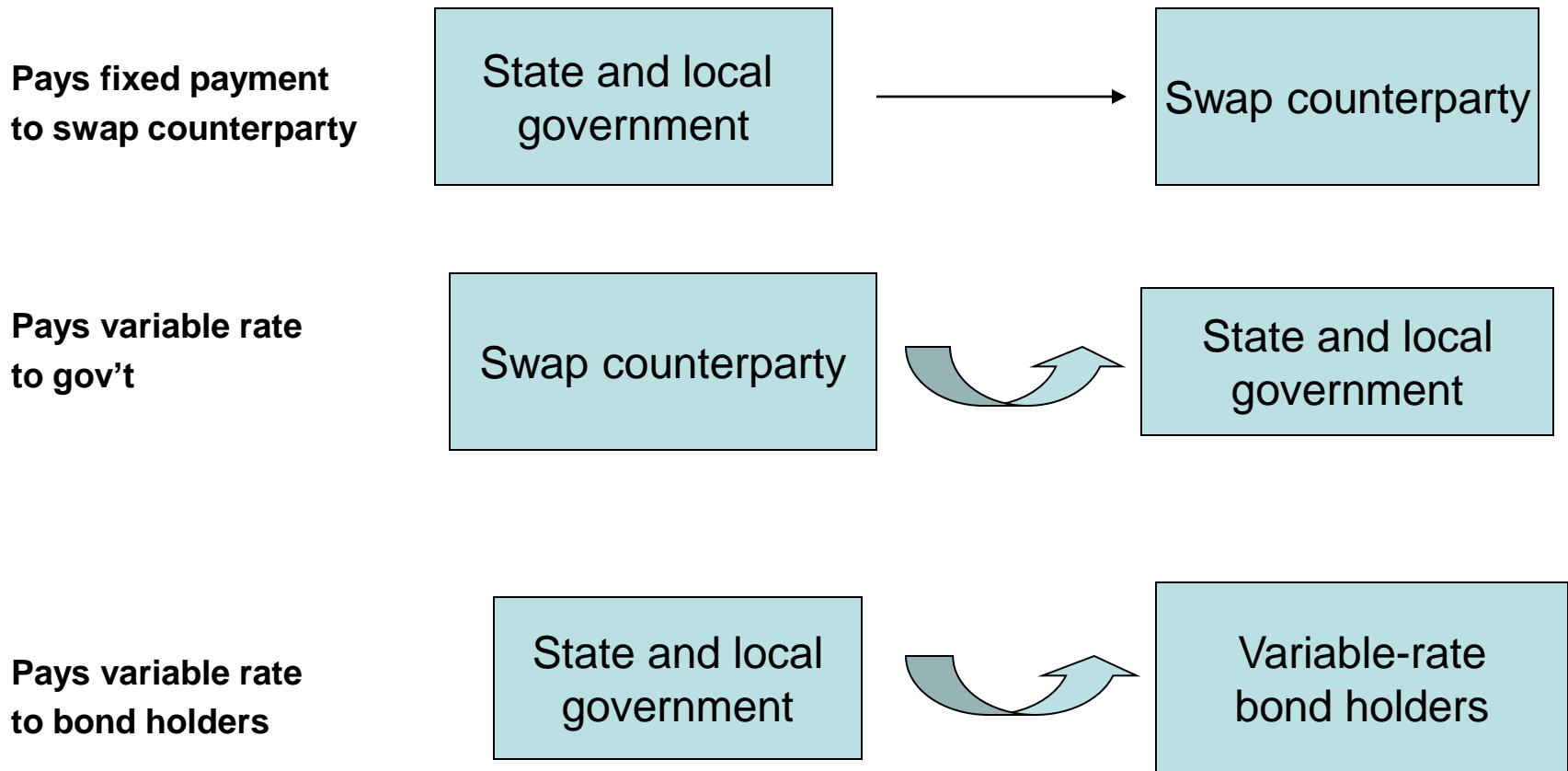
Hedgeable items

- Single asset or liability
- Groups of similar assets / liabilities that have same risk exposure
- Expected transaction – occurrence should be probable
- Specific risks of financial instruments are hedgeable – ex. – interest rate risk

Do not qualify:

- Transactions within the primary gov't
- Investments, if they are reported at fair value

Cash flow hedge – variable-rate debt



Evaluating effectiveness

Qualitative method

- Consistent critical terms

Quantitative method

- Synthetic-instrument method
- Dollar-offset method
- Linear-regression method
- Other qualifying methods

Consistent critical terms

- Notional and principal amounts must be the same
- Fair value of derivative must be zero at date of inception
- Benchmark rates based on the same index such as SIFMA to SIFMA or cost of funds (i.e., cost the gov't is paying bondholders)
- Additional requirements depending on if it's a cash flow or fair value hedge

Cash flow – potential hedge

- Formula for payments are consistent during the contract – both legs
- If floor or cap – comparable for both legs
- Designated maturity or reset periods are similar for both legs
- Reset dates within 6 days of each other
- Payments are within 15 days of each other

Consistent critical terms

| | <u>Hedged Debt</u> | <u>Hedging Derivative</u> |
|------------------------------------|--------------------|---------------------------|
| Principal / notional amount | \$1,000 | \$1,000 |
| Term | 10 years | 10 years |
| Payments, every | 6 months | 6 months |
| Variable payment | SIFMA | SIFMA |

Synthetic-instrument method

- Comes from the consistent critical terms method, but used when the benchmark rates are not the same, such as a percentage of LIBOR swap
- Uses the rate in the fixed-leg of the swap as the fixed rate
 - As long as the actual payments are within a range of 90% - 111% of the fixed rate, it's effective
 - Can use hypothetical payments based on past events (at initial inception of instrument)

Synthetic-instrument method

| | |
|----------------------------|--------------|
| Expected fixed rate | 5.00% |
| Actual fixed rate: | |
| * Swap fixed rate | 5.00% |
| * Swap variable rate | (1.25%) |
| * Variable rate bonds rate | <u>1.35%</u> |
| Actual fixed rate | 5.10% |

Actual rate needs to be within range of 4.50% - 5.55% (90%-111% of 5.00%).

Dollar-offset method

- The change in fair values or cash flows of the hedging derivative instrument is divided by the same changes of the hedged item. The result should be within the range of 80-125%.
- If it falls outside this range during the term, it becomes ineffective and is no longer a hedge for the rest of the term.

Dollar-offset method

Changes

Fair value change

Hedged debt

\$1,000

Interest rate swap

(1,150)

$(\$1,000 / \$1,150) = 89.96\%$

Hedge terminations

Recognized the amount deferred in the income statement if:

- The derivative is no longer effective.
- The gov't is re-exposed to the hedged risk through counterparty issues, insurance issues, etc.
- The likelihood of the expected transaction is no longer probable.
- The derivative instrument is terminated.

Hedge terminations

Hedged transaction occurs, examples:

- A futures contract is hedging the purchase of natural gas.
- An interest-rate lock is hedging interest rate risk in anticipation of the issuance of bonds, and the bonds are issued.

Disclosures

- Summary of derivative instrument activity by:
 - Government activities, business-type activities and fiduciary activities
 - Then by fair-value hedges, cash-flow hedges and investment-derivative instruments
 - Then by notional amount, fair values with changes and where reported

Disclosures

- Hedging instruments: apply Technical Bulletin 2003-1 – significant terms, risks
 - Not required to disclose hedge effectiveness
- Investment derivatives: risks, including credit, interest rate and foreign currency risk

Effective date and other guidance

- Effective: for periods beginning after June 15, 2009
- Guide to Implementation of GASB 53
- Derivatives – Plain-Language Summary

GASB 54

Fund Balance

Why is fund balance important?

- One of the most-used pieces of information in gov't financial statements: what are the available liquid resources that can be used to repay long-term debt, reduce property taxes, add new gov't programs, expand existing ones, or enhance the financial position of the gov't?
- Used in credit reviews by municipal bond analysts
- Used by taxpayer associations, oversight agencies, legislators, etc.

GASB concerns

Fund balance is often misunderstood by both preparers and users of F/S.

There are variations in the way gov'ts report fund balance – undermines its usefulness.

Users do not understand the difference between reserved and unreserved fund balance. Also, confusion about relationship to restricted net assets under GASB 34 statements.

GASB concerns (cont'd)

- Transfers from general fund to other funds, with subsequent transfers back
- Reporting of “reserved” fund balance when the restriction is not more specific than the purpose of the fund.
- Some gov'ts report designated fund balance, others do not (optional)
- Lack of clear definitions of fund types

Current practice

Reserved fund balance:

- resources that are not in spendable form (inventory, LT loans receivable), or
- are “legally segregated” for a purpose more specific than the overall purpose of the fund
 - Encumbrances
 - Categorical grants (maybe)

Current practice – general fund

Example: assume general fund has capital projects, grants activity

| | <u>General fund</u> | <u>Special revenue fund</u> | <u>Capital projects fund</u> |
|-------------------------|---------------------|-----------------------------|------------------------------|
| Reserved for: | | | |
| Capital projects | \$100 | | |
| Grants | \$100 | | |
| Unreserved | \$100 | | |

Current practice – general fund

Example: assume capital projects and grants activity occur in other funds

| | <u>General fund</u> | <u>Special revenue fund</u> | <u>Capital projects fund</u> |
|-------------------------|---------------------|-----------------------------|------------------------------|
| Reserved for: | | | |
| Capital projects | | | |
| Grants | | | |
| Unreserved | \$100 | \$100 | \$100 |

New approach

Classification hierarchy based on the extent to which a gov't is bound to honor constraints on the specific purposes for which amounts in those funds can be spent.

- 1) What are the limits?
- 2) Who says so?

New classifications

- Nonspendable
 - Restricted
 - Committed
- } essentially now ***reserved***
- Assigned
 - Unassigned
- } essentially now ***unreserved***

Nonspendable fund balance

- Not in spendable form
 - Inventory
 - Long-term receivables not expected to be converted to cash in the near term
- Legally or contractually required to be maintained intact
 - Corpus of a permanent fund (endowment)
 - Revolving loan fund – core funds to remain

Restricted fund balance

- Essentially the same definition as for net assets under GASB 34 (as amended by 46)
 - External parties
 - Constitutional provisions
 - Enabling legislation

* Externally Enforceable*

Committed fund balance

- Constraint on use imposed by the government itself, using its highest level of decision-making authority
- Constraint can be removed or changed only by taking the same action
- Action to constrain resources should occur before the end of the year, though the exact amount may be determined later

Assigned fund balance

- Amounts intended to be used for specific purposes – similar to current “designated, unreserved fund balance”
- Intent expressed by
 - The governing body
 - A body (budget or finance cmte.) or official authorized by the governing body
- Residual amounts in governmental funds other than the general fund are assigned
- Appropriation of existing fund balance

Unassigned fund balance

- Available for any purpose
- Reported only in the general fund, except in cases of negative fund balance
 - Negative balances in other governmental funds are reported as unassigned (cannot “assign” a negative balance)

New practice – general funds

Example: assume capital projects and debt service activities occur in the general fund

| | <u>General fund</u> | <u>Debt service fund</u> | <u>Capital projects fund</u> |
|---------------------------------------|---------------------|--------------------------|------------------------------|
| Restricted for debt service | \$100 | | |
| Committed for capital projects | \$100 | | |
| Unassigned | \$100 | | |

New practice – all funds

Example: assume capital projects and debt service activities occur in other funds

| | <u>General fund</u> | <u>Debt service fund</u> | <u>Capital projects fund</u> |
|---------------------------------------|---------------------|--------------------------|------------------------------|
| Restricted for debt service | | \$100 | |
| Committed for capital projects | | | \$100 |
| Unassigned | \$100 | | |

Encumbrances

- Encumbrances should not be displayed separately within the restricted, committed and assigned categories.
- Amounts are classified as restricted, committed, and assigned based on the source and strength of the constraints placed on them – encumbering those amounts does not further affect them.

Encumbrances

- The concept of an encumbrance is based on budgetary availability – reserving resources that can't be used for next year's budget.
- GASB 54 focus is on distinguishing the extent to which purpose limitations have been established regarding use of amounts.

Encumbrances

- For example, an amount could be classified as Restricted for a specific purpose, some or all of which may be encumbered.
- Encumbering the amount does nothing to further restrict the amount, so it should not be shown on the face of the statements.

Encumbrances

- If you have encumbrance accounting, encumbrances will be reported as either:
- Committed – if approved by action of the highest decision-making authority
 - Board votes to allocate \$300,000 of fund balance for purchase of a new fire truck.
 - Assigned – resulting from the issuance of purchase orders as a result of normal purchasing activity approved by appropriate officials
 - This will be the most common classification.

Example – next year's budget

- In order to balance the next year's budget, the city budgets the use of \$1.5 million of carryover fund balance.
- Does this have an impact on fund balance reporting at the end of the current year?

Example – construction contract

- The capital projects fund has a \$10 million in outstanding construction contract.
- The project is funded by:
 - \$5 million in bond proceeds, which have been received
 - \$3 million in local funds that are in the capital project fund for the project
 - \$2 million to come from a general fund transfer next year

Example: Stabilization (rainy-day) amounts

- Stabilization was not previously considered a specific purpose.
- If constraints on stabilization amounts meet criteria to be reported as restricted or committed, then stabilization can be considered a specific purpose.
- Stabilization amounts should NOT be reported as assigned.

Stabilization amounts - other

- Stabilization is regarded as a specified purpose only if the circumstances that signal the need for stabilization:
 - Are identified in sufficient detail, and
 - Are not expected to occur routinely

Presentation & disclosure

- May present details on face of the financial statements, or in the footnotes
- Disclose:
 - Nonspendable by type
 - Restrictions by purpose
 - Commitments and assignments in sufficient detail that major purposes are evident to the reader

Fund definitions

Special Revenue Funds: used to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects.

- Specific revenue source: one or more specific restricted or committed revenues should be the foundation for the fund.

Special revenue funds

- The specific revenue sources should comprise a substantial portion of a fund's resources.
- If revenues are initially received in another fund, they should NOT be reported as revenues in the fund receiving them; instead, they should be recognized in the special revenue fund where they will be spent.
- Discontinue reporting a special revenue fund (and move to the general fund) if the gov't no longer expects a substantial portion of revenues will be derived from restricted revenue sources.

Special revenue funds - example

| | Special District | School Reserve | Economic Development | Major Projects | Science Center |
|--------------------|------------------|----------------|----------------------|----------------|----------------|
| Revenues: | | | | | |
| Property taxes | \$1,500,000 | \$0 | \$0 | \$0 | \$0 |
| Charges for svcs | 0 | 0 | 475,000 | 0 | 6,000,000 |
| Investment inc. | 45,000 | 0 | 50,000 | 1,500,000 | 22,000 |
| Expenditures | 950,000 | 0 | 9,900,000 | 300,000 | 7,000,000 |
| Transfers In (Out) | 0 | 0 | 9,100,000 | (1,300,000) | 1,000,000 |
| Fund balance, BOY | 1,100,000 | 4,000,000 | 900,000 | 28,000,000 | 125,000 |
| Fund balance, EOY | \$1,695,000 | \$4,000,000 | \$625,000 | \$27,900,000 | \$147,000 |

Special revenue funds: disclosure

- Disclose purpose of each major special revenue fund, and each revenue source or other resources authorized to be reported in each.

Capital project fund: definition

- Used to account for and report financial resources that are restricted, committed, or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets
 - Excludes capital outflows financed by proprietary funds or for assets that will be held in trust for individuals, private organizations or other gov'ts.

Debt service fund: definition

- Used to account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest.

Note disclosures

- Description of authority and actions that lead to committed and assigned fund balance
- Encumbrances, if significant, are disclosed in conjunction with other disclosures of significant commitments
- Spending prioritization policies
 - Use of restricted vs. unrestricted
 - Committed, assigned, unassigned

Note disclosures

- Stabilization arrangements
 - Authority for establishing
 - Requirements for additions
 - Conditions under which amounts may be used
- Minimum fund balance policies

Fund balance policies

- Generally applies to the general fund
- The following should be addressed:
 - The appropriate level of unrestricted fund balance to be maintained in the general fund
 - Can be expressed as a minimum amount or a range between amounts
 - The circumstances in which unrestricted fund balances can be “spent down”
 - The policy for replenishing deficiencies
 - Should indicate source of funding and time period for replenishment to occur

Effective date

- Effective for periods beginning after June 15, 2010
- Consider implications now, as changes to fund definitions and other actions may need to be taken during the next budget cycle.

GASB 54 steps to take

- Review fund structure (definitions).
- Review / establish fund balance policy.
- Be sure that appropriate Board action is taken to ensure funds can be shown as committed.
- Establish / strengthen control processes to track changes in committed and assigned funds.

Questions?

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