University of California

Governmental Accounting Standards Board (GASB) Statement No. 59*, Financial Instruments Omnibus*

Issues Resolution Memo No. 59-1

Evaluation of GASB Statement No. 59 as it Relates to the UC Reporting Entities

Issued: May 4, 2011

Background

Governmental Accounting Standards Board (GASB) Statement No. 58, *Financial Instruments Omnibus* improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice.

This Statement provides for the following amendments:

- National Council on Governmental Accounting Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, is updated to be consistent with the amendments to GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, regarding certain financial guarantees.

- Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, are amended to remove the fair value exemption for unallocated insurance contracts. The effect of this amendment is that investments in unallocated insurance contracts should be reported as interest-earning investment contracts according to the provisions of paragraph 8 of Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*.

- Statement No. 31, is clarified to indicate that a 2a7-like pool, as described in Statement 31, is an external investment pool that operates in conformity with the Securities and Exchange Commission's (SEC) Rule 2a7 as promulgated under the Investment Company Act of 1940, as amended.

- Statement No. 40, *Deposit and Investment Risk Disclosures*, is amended to indicate that interest rate risk information should be disclosed only for debt investment pools—such as bond mutual funds and external bond investment pools—that do not meet the requirements to be reported as a 2a7-like pool.
- Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments,* is amended to:

- Clarify that the net settlement characteristic of Statement No. 53 that defines a derivative instrument is not met by a contract provision for a penalty payment for nonperformance;

- Provide that financial guarantee contracts included in the scope of Statement No. 53 are limited to financial guarantee contracts that are considered to be investment derivative instruments entered into primarily for the purpose of obtaining income or profit;

- Clarify that certain contracts based on specific volumes of sales or service revenues are excluded from the scope of Statement No. 53; and

- Provide that one of the "leveraged yield" criteria of Statement No. 53 is met if the initial rate of return on the companion instrument has the potential for at least a doubled yield.

Define Issues

The University must determine whether GASB Statements No. 59 changes any existing financial reporting and disclosure requirements for any of the University's financial reporting entities.

The National Council on Governmental Accounting (NCGA) and the GASB have addressed accounting and financial reporting of certain financial instruments in NCGA Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, and GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*; No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*; No. 40, *Deposit and Investment Risk Disclosures*; No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*; and No. 53, *Accounting and Financial Reporting for Derivative Instruments*. The objective of this Statement is to update and improve the accounting and financial reporting requirements of these pronouncements that address financial instruments.

This Statement supersedes the following:

- Statement 31, paragraph 12
- Statement 53, paragraph 16

The Statement also amends the following:

- NCGA Statement 4, paragraph 9
- GASB Statement 25, paragraphs 24 and 44
- Statement 31, paragraph 22
- Statement 40, paragraph 15
- Statement 43, paragraphs 22 and 46
- Statement 53, paragraphs 13, 17, and 64c(5)(a).

This Statement applies to all state and local governments.

Effective Date

The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2010. Earlier application is encouraged.

Analysis and Conclusions

Amendment to GASB Statement No. 53

GASB Statement No. 59, Paragraph 3 states:

> To be consistent with the amendments to Statement 53 regarding certain financial guarantees, NCGA Statement 4, paragraph 9, is amended by replacing the second sentence as follows:
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> > Those claims include contractual actions, such as claims for delays or inadequate specifications on contracts, or for guarantees of the indebtedness of others that are not investment derivative instruments entered into primarily for the purpose of obtaining income or profit, property tax appeals, and unemployment compensation claims.

This amendment is noted and not considered to have any impact on the University.

Amendments to Statements No. 25 and 43—Unallocated Insurance Contracts

GASB Statement No. 59, Paragraph 4 states:

> Investments in unallocated insurance contracts should be reported as interest-earning investment contracts according to the provisions of paragraph 8 of Statement 31. Paragraph 8 provides guidance for contracts that participate in fair value changes and those contracts that do not participate in fair value changes. Statement 25, paragraph 24, and Statement 43, paragraph 22, are amended to be consistent with the Statement 31 provisions as follows:
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> > Plan investments, whether equity or debt securities, real estate, or other investments should be measured at fair value at the reporting date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller—that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If such prices are not available, fair value should be estimated. Unallocated insurance contracts should be reported as interest-earning investment contracts according to the provisions of paragraph 8 of Statement 31. Allocated insurance contracts should be excluded from plan assets.

The University's investments in Guaranteed Investment Contracts (GIC) are nonparticipating interest-earning investment contracts, such as nonnegotiable certificates of deposit with redemption terms that do not consider market rates. The University will continue to report investments in these GICs using a cost-based measurement in accordance with the provisions of paragraph 8 of Statement 31.

Amendments to Statement No. 31—2a7-Like External Investment Pools

GASB Statement No. 59, Paragraph 5 states:

> 2a7-like pools, as described in Statement 31, are external investment pools that operate in conformity with the Securities and Exchange Commission's (SEC) Rule 2a7 as promulgated under the Investment Company Act of 1940, as amended. Statement 31, paragraph 12, is superseded as follows:
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> > Investments in 2a7-like pools should be measured at the net asset value per share provided by the pool. A 2a7-like pool is an external investment pool that operates in conformity with the Securities and Exchange Commission's (SEC) Rule 2a7 as promulgated under the Investment Company Act of 1940, as amended. The net asset value per share generally is calculated on a basis other than fair value, such as by the "amortized cost" method that provides a net asset value per share that approximates fair value. To qualify as a 2a7-like pool, the pool should satisfy all SEC requirements of Rule 2a7, including that a group of individuals fulfills the functions of a board of directors. The following conditions do not preclude a pool from being considered 2a7-like:
> >
> > a. The principal executive officer of the pool, who can be an elected official, has the power to enter into contracts and make personnel decisions; however, investment policies should nevertheless be set by the group of individuals that fulfills the functions of a board of directors.
> >
> > b. The pool is not required to register with the SEC.

The University established STIP as an external investment pool, not designed to operate in accordance with SEC Rule 2a-7. A money market fund that qualifies as a 2a-7 pool is traded at a stable net asset value of $1 per share and generally has to comply with the following criteria:

- The fund is permitted to value investments at amortized cost so long as the deviation between amortized cost and fair value is minimal;
- Periodically, the fund manager is required to "shadow price" the fund to compare the net asset value using amortized cost to the net asset value using fair market values for portfolio investments;
- The funds pay dividends that reflect prevailing market rates; and
- The funds are required to comply with investment restrictions established by the SEC designed to limit the fund's exposure to certain risks, such as credit, currency, and interest rate risks.

While STIP is traded at a stable $1 value, the fund is not organized as a 2a-7 pool. The most significant differences are as follows:

- The investments held by STIP are carried at market value, not amortized cost, on the books of the University.
- Monthly distributions to account holders are determined by comparing the investment yield of the portfolio to the amortized cost value of the portfolio since substantially all the assets purchased in the portfolio are held to maturity.

- The University's investment policies govern the investments that are permitted in STIP and the guidelines are designed to meet the liquidity needs of the University.
- STIP is designed to maximize income on short-term cash balances by taking advantage of the economies of scale of investing in a larger pool and investing in a broader range of maturities. While there are some holders of STIP that are organizations legally separate from, although closely related to, the University, these holders represent less than 1 percent of STIP holdings ($72 million as of June 30, 2010 as compared to the total value of STIP of over $9 billion). STIP has been designed as the University's investment vehicle to earn income on unused cash balances while meeting the short-term liquidity needs of the University.
- The University (specifically the Office of the President) has agreed to bear all the risk for unrealized gains and losses associated with the fluctuation in the fair value of investments included in STIP. The holders of STIP, including the campuses, medical centers, foundations and other legally separate entities, do not receive any benefits or bear any risks associated with credit quality, interest rate or duration of the investments held in STIP.

Because STIP is not organized as a 2a-7 pool, this change is not applicable to the University.

Amendment to Statement No. 40—Interest Rate Risk Disclosures for Debt Investment Pools

GASB Statement No. 59, Paragraph 6 states:

> The interest rate risk disclosure for a government's investments in mutual funds, external investment pools, or other pooled investments should be limited to investments in debt mutual funds, external debt investment pools, or other pooled debt investments. Statement 40, paragraph 15, is amended by replacing the last sentence as follows:
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> > Governments that report debt investment pools—such as bond mutual funds and external bond investment pools—that do not meet the requirements to be reported as a 2a7-like pool should disclose interest rate risk information according to one of the methods above.

The University is in compliance with this requirement; effective duration is reported for all fixed or variable income securities, including mutual funds and other pooled investments. Duration is also reported for all of the investments held in STIP. The University has concluded that commingled balanced funds are not subject to interest rate risk disclosure since there is no interest rate risk profile for equity securities.

Amendments to Statement No. 53—Contracts That Include Nonperformance Penalties

GASB Statement No. 59, Paragraph 7 states:

> Contract nonperformance penalties do not meet the net settlement characteristic included in the definition of a derivative instrument. Statement 53, paragraph 13, is amended by adding the following sentences at the end of the paragraph:
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> > Some construction or purchase contracts include nonperformance penalty provisions. A penalty payment for nonperformance, either fixed or variable, that is dependent on the failure of the counterparty to comply with a contract term does not meet the net settlement characteristic.

As of June 30, 2010, the University did not have these types of investments. Applicability of this requirement will be considered as of June 30, 2011.

Amendments to Statement No. 53—Certain Financial Guarantee Contracts

GASB Statement No. 59, Paragraph 8 states:

Financial guarantee contracts included in the scope of Statement 53 are limited to financial guarantee contracts that are considered to be investment derivative instruments entered into primarily for the purpose of obtaining income or profit. Statement 53, paragraph 16, is superseded as follows:

> A financial guarantee contract that meets the definition of a derivative instrument and is not entered into as an investment derivative instrument primarily for the purpose of obtaining income or profit is outside the scope of this Statement. Examples are as follows:
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> a. A federal guarantee that protects a university from loss in its student accounts receivables
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> b. A guarantee a state government provides for the nonpayment of the debt of an industrial development corporation
>
> c. Bond insurance in which the government pays the premium, the bond insurance is associated with the government's debt, and the debt holder is the beneficiary.
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> Financial guarantee contracts are included in the scope of this Statement if they meet the definitions of a derivative instrument and an investment derivative instrument entered into primarily for the purpose of obtaining income or profit. An example is a credit default swap that a government enters into to take a position for gain or income in response to changes in a reference rate, such as a contract that provides for payments to be made if the credit rating of a debtor falls below a particular level.

As of June 30, 2010, the University did not have any investments in default swap investment. Applicability of this requirement will be considered as of June 30, 2011.

Amendments to Statement No. 53—Revenue-Based Contracts

GASB Statement No. 59, Paragraph 9 states:

> Contracts that are not exchange-traded and have reference rates based on specific volumes of sales or service revenue of one of the parties to the contract are excluded from the scope of Statement 53. Statement 53, paragraph 17, is amended by adding the following subparagraph:
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> c. Specific volumes of sales or service revenues of one of the parties to the contract, such as a lessee's sales or volumetric production payments associated with an oil or gas well.

The University entered into the Agency Agreement with Farmers National Company ("Agent"). Agent shall manage various oil, gas and mineral properties. University agrees that Agent have authority to execute oil and gas leases, rights of way agreements, lease option agreements, etc.

Revenues generated from oil and gas rights are dependent on the volume of production. Therefore, they are excluded from the scope of Statement No. 53.

Amendments to Statement No. 53—Hybrid Instruments: Investor's Initial Rate of Return

GASB Statement No. 59, Paragraph 10 states:

> One of the criteria for determining whether a hybrid instrument should be reported according to the provisions of Statement 53 is that there is the potential for at least a doubled yield on an investor's initial rate of return on the companion instrument. Statement 53, paragraph 64c (5) (a), is amended as follows:
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> a. The holder's initial rate of return on the companion instrument has the potential for at least a doubled yield.

The only hybrid instrument held by the University is the interest rate swap used as a cash flow hedge for the UCLA Medical Center variable rate bonds. At the inception of the transaction, the initial rate of return on the companion instrument did not have the potential for at least a doubled yield, so this change does not apply to the University.

Next Steps—Required Actions

None.