

# Governmental Accounting Standards Series

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EXPOSURE DRAFT

## Proposed Statement of the Governmental Accounting Standards Board

### **Financial Instruments Omnibus**

This Exposure Draft of a proposed Statement of Governmental Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Research and Technical Activities  
Project No. 26-3

Comment Deadline: October 30, 2009



Governmental Accounting Standards Board  
of the Financial Accounting Foundation

# FINANCIAL INSTRUMENTS OMNIBUS REQUEST FOR WRITTEN COMMENTS

**Deadline for submitting written comments:** October 30, 2009

**Requirements for written comments.** Comments should be addressed to the Director of Research and Technical Activities, Project No. 26-3, and emailed to [director@gasb.org](mailto:director@gasb.org) or mailed to the address below.

## OTHER INFORMATION

**Public hearing.** The Board has not scheduled a public hearing on the issues addressed in this Exposure Draft.

**Public files.** Written comments will become part of the Board's public file and will be available for inspection at the Board's offices. Copies of those materials may be obtained for a specified charge.

**Orders.** Any individual or organization may obtain one copy of this Exposure Draft on request without charge until October 30, 2009, by writing or phoning the GASB Order Department. For information on prices for additional copies and copies requested after October 30, please contact the Order Department. The Exposure Draft also may be downloaded from the GASB's website at [www.gasb.org/exp](http://www.gasb.org/exp).

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## **Notice to Recipients of This Exposure Draft**

The Governmental Accounting Standards Board (GASB) is responsible for developing standards of state and local governmental accounting and financial reporting and other accounting and financial reporting communications that will (1) result in useful information for users of financial reports and (2) guide and educate the public, including issuers, auditors, and users of those financial reports.

The due process procedures that we follow before issuing our standards and other communications are designed to encourage broad public participation in the standards-setting process. As part of that due process, we are issuing this Exposure Draft setting forth a proposed Statement that would modify existing standards concerning financial instruments. Appendix C presents the proposed modifications in a markup format. This appendix is provided so that readers of the Exposure Draft can more easily see how these proposed modifications would specifically affect the existing GASB literature. This appendix will not appear in the final standard.

We invite your comments on all matters in this proposed Statement. Because this proposed Statement may be modified before it is issued as a final Statement, it is important that you comment on any aspects with which you agree as well as any with which you disagree. To facilitate our analysis of comment letters, it would be helpful if you explain the reasons for your views, including alternatives that you believe we should consider.

All responses are distributed to the Board and to staff members assigned to this project, and all comments are considered during the Board's deliberations leading to a final Statement. When the Board is satisfied that all alternatives have adequately been considered and modifications, if any, have been made, a vote is taken on the Statement. A majority vote is required for adoption.

## Summary

The objective of this proposed Statement is to revise 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 Exposure Draft presents proposals for the following amendments:

- 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*, would be amended to remove the fair value exemption for unallocated insurance contracts. The effect of this amendment would be that unallocated insurance contracts would be measured at fair value instead of contract value.
- Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, would be amended to indicate that a 2a7-like pool, as described in Statement 31, is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company but that operates in a manner compliant with the SEC’s Rule 2a7.
- Statement No. 40, *Deposit and Investment Risk Disclosures*, would be amended to indicate that interest rate risk information should be disclosed only for *bond* mutual funds that do not meet the requirements of a 2a7-like pool.
- Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, would be amended to:
  - Clarify that the net settlement characteristic of Statement 53 that defines a derivative instrument would not be satisfied by a contract provision for a penalty payment for nonperformance.
  - Provide that certain financial guarantees would no longer be exempted from the scope of Statement 53. The effect of this amendment is that certain financial guarantees, and specifically certain credit default swaps, would be measured at fair value.
  - Clarify that certain contracts based on a specific volume of sales or service revenues would be excluded from the scope of Statement 53.
  - Provide that the “leveraged yield” criteria of Statement 53 would be met if the initial rate of return on the companion instrument has the *potential* for at least a doubled yield.

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

## How the Changes in This Proposed Statement Would Improve Financial Reporting

The requirements of this proposed Statement would improve financial reporting by providing more complete information, by improving consistency of measurements, and by providing clarifications of existing standards. Extending a fair value measurement to unallocated insurance contracts would improve consistency of investment measurements

that are reported by pensions and other postemployment benefit plans. Emphasizing the applicability of SEC requirements to 2a7-like external investment pools would provide practitioners with improved guidance on the relevance of complying with those requirements. Limiting interest rate risk disclosures for investments in mutual funds to bond mutual funds would provide better guidance regarding the applicability of interest rate risk disclosures. Finally, addressing the applicability of Statement 53 to certain financial instruments would refine which financial instruments are within the scope of that standard.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental 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. Paragraph 2 discusses the applicability of this Statement.

# Proposed Statement of the Governmental Accounting Standards Board

## Financial Instruments Omnibus

June 30, 2009

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# **Proposed Statement of the Governmental Accounting Standards Board**

## **Financial Instruments Omnibus**

**June 30, 2009**

### **INTRODUCTION**

1. The GASB addresses accounting and financial reporting of certain financial instruments and external investment pools in 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.

### **STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING**

#### **Scope and Applicability of This Statement**

2. This Statement supersedes Statement 31, paragraph 12, and Statement 53, paragraph 16. It also amends National Council on Governmental Accounting Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, paragraph 9; Statement 25, paragraphs 24 and 44; Statement 31, paragraph 22; Statement 40, paragraph 15; Statement 43, paragraphs 22 and 46; and Statement 53, paragraphs 13, 17, and 64c(5). This Statement applies to all state and local governments.

#### **Amendments to Statements 25 and 43—Unallocated Insurance Contracts**

3. Investments in unallocated insurance contracts should be measured at fair value. The first sentence of Statement 25, paragraph 24, and the first sentence of Statement 43, paragraph 22, are amended as follows:

Plan investments, whether equity or debt securities, real estate, or other investments should be measured at fair value at the reporting date.

In addition, the penultimate sentence of Statement 25, paragraph 24, and the penultimate sentence of Statement 43, paragraph 22, are deleted. The glossary entries for *contract value*, *insurance contract*, and *unallocated insurance contract* are deleted from Statement 25, paragraph 44, and Statement 43, paragraph 46.

## **Amendments to Statement 31—2a7-Like External Investment Pools**

4. The following paragraph supersedes Statement 31, paragraph 12:

Investment positions in 2a7-like pools should be determined by each pool's net asset value per share established by the sponsors. A 2a7-like pool is an external investment pool that is not registered with the SEC as an investment company but operates in a manner that is compliant with the SEC's Rule 2a7 (17 *Code of Federal Regulations* §270.2a7). In other words, if the pool had registered with the SEC, the pool's daily activities would satisfy all SEC requirements of Rule 2a7.

The glossary entry for *2a7-like pool* is deleted from Statement 31, paragraph 22.

## **Amendment to Statement 40—Interest Rate Risk Disclosures for Bond Mutual Funds**

5. The interest rate disclosure for a government's investment in a mutual fund should be limited to an investment in a *bond* mutual fund. Statement 40, paragraph 15, is amended by replacing the last sentence with the following:

Governments with investments in bond mutual funds, external investment pools, or other pooled investments that do not meet the requirements of a 2a7-like pool should disclose interest rate risk information according to one of the methods above.

## **Amendments to Statement 53**

### **Contracts That Include Nonperformance Penalties**

6. A contract's nonperformance penalty does not meet the net settlement characteristic that defines a derivative instrument. Statement 53, paragraph 13, is amended by adding the following sentences:

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.

### **Certain Financial Guarantee Contracts**

7. Financial guarantee contracts that are associated with a government's debt investment should be reported according to the provisions of Statement 53. Statement 53, paragraph 16, is superseded by the following:

*Certain financial guarantee contracts.* A financial guarantee contract—also known as a credit default swap—is excluded from the scope of this Statement if (a) a government pays the premium, (b) the swap is associated with the

government's debt, and (c) the debt holder is the beneficiary. Financial guarantee contracts, however, that meet the definition of a derivative instrument, but do not meet all three of the foregoing criteria, are within the scope of this Statement. Examples of financial guarantee contracts that are included in this Statement are contracts that provide for payment to be made:

- (1) To reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the terms of a debt instrument or violates a debt covenant
- (2) 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.

### **Revenue-Based Contracts**

8. Statement 53 does not apply to a contract that is not exchange-traded and has a reference rate based on the specific volumes of sales or service revenue of one of the parties to the contract. A new subparagraph is added to Statement 53, paragraph 17, as follows:

- 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.

### **Hybrid Instruments—Investor's Initial Rate of Return**

9. A criterion for determining whether a hybrid instrument should be reported according to the provisions of Statement 53 is that there is a leveraged yield. For a hybrid instrument to have a leveraged yield, the investor's initial rate of return on the companion instrument should have the potential for at least a doubled yield. Statement 53, paragraph 64c(5)a, is amended to read as follows:

- a. The holder's *initial* rate of return on the companion instrument has the potential for at least a doubled yield.

### **EFFECTIVE DATE AND TRANSITION**

10. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2010. Earlier application is encouraged. In the first period that this Statement is applied, changes made to comply with this Statement should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. If restatement of the financial statements for prior periods is not practical, the cumulative effect of applying this Statement should be reported as a restatement of beginning net assets (or equity or fund balance, as appropriate) for the earliest period restated (generally the current period). In the first period that this Statement

is applied, the financial statements should disclose the nature of the restatement and its effect.

**The provisions of this Statement need  
not be applied to immaterial items.**

## **Appendix A**

### **BACKGROUND**

11. Several GASB pronouncements have addressed accounting and financial reporting for financial instruments. Since the issuance of 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. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*; and No. 53, *Accounting and Financial Reporting for Derivative Instruments*, various issues have arisen in practice regarding certain financial instruments.

12. At the July 2006 Board meeting, an initial investments omnibus project was identified as a potential addition to the agenda. The project's objective was to research potential amendments to Statements 31 and 40. At its July 2007 meeting, the Governmental Accounting Standards Advisory Council provided feedback and considered this project to be a priority. The project was placed on the Board's research agenda at its August 2007 meeting. The research also identified potential amendments to Statements 25 and 43 regarding unallocated insurance contracts. Finally, in the development of the Implementation Guide on derivative instruments in 2008, potential revisions to Statement 53 became apparent. This research was presented to the Board at the Board's December 2008 meeting. At that meeting, the project was renamed the financial instruments omnibus project and was added to the Board's current technical agenda.

## **Appendix B**

### **BASIS FOR CONCLUSIONS**

13. This appendix discusses factors considered significant by Board members in reaching the conclusions in this Statement. It includes discussion of the alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members may have given greater weight to some factors than to others.

#### **Scope**

14. The initial objective of this project was to address five topic areas—unallocated insurance contracts, 2a7-like external investment pools, interest rate risk disclosures for bond mutual funds, custodial credit risk of deposits that are placed through deposit placement services, and reporting realized gains and losses. Through Board deliberations, it was concluded that the issue of custodial credit risk of deposits that participate in deposit placement services will be addressed in the *Comprehensive Implementation Guide*, and the issue of reporting realized gains and losses is expected to be addressed in a future project. Additionally, issues that had arisen since the issuance of Statement 53 were discussed, although that pronouncement was not effective as of the date of this project. Those issues—consisting of contracts that include nonperformance penalties, the scope exception for financial guarantee contracts, the scope exception for revenue-based contracts, and investor's initial rate of return for hybrid instruments—were considered by the Board and included in the scope of this Statement.

#### **Unallocated Insurance Contracts**

15. Statements 25 and 43 provide that employee benefit plan assets should be measured using fair value, with the exception of unallocated insurance contracts. Those contracts were measured at contract value (a cost-based measure). The primary difference between an *unallocated insurance contract* and an *allocated insurance contract* is how the monies are held by the insurance company. An unallocated insurance contract is one in which the payments to the insurance company are accumulated in a pooled account and are not allocated to a specific member. An allocated insurance contract is one in which the payments to the insurance company are used to purchase immediate or deferred annuities for a specific member. Unallocated insurance contracts in employee benefit plans are monies received from employers that have not been used to purchase annuities and are held by the plans as investments. As such, the Board determined it is more appropriate that such contracts be measured at fair value, consistent with other investments.

#### **2a7-Like External Investment Pools**

16. Statement 31 provides guidance on the reporting of external investment pools and generally requires external investment pools to be reported at fair value on the statement of net assets. An exception was provided when an external investment pool "has a policy that it will, and does, operate in a manner consistent with the SEC's [Securities and

Exchange Commission] Rule 2a7 of the Investment Company Act of 1940” (Statement 31, paragraph 22). These external investment pools are referred to as 2a7-like pools in Statement 31. The concept is that the investments held by a 2a7-like pool are of very high credit quality and short maturity. The high credit quality requirement is intended to limit the investment portfolio’s credit risk, and the short maturity requirement is intended to limit interest rate risk. These requirements, working together, are designed to keep the pool’s net asset value on a fair value basis very close to its value on an amortized cost basis.

17. In SEC practice, only mutual funds that meet the requirements of Rule 2a7, which includes filing with the SEC, are entitled to be labeled as money market funds. The GASB’s intent is that a 2a7-like external investment pool is a governmental external investment pool that, if it was under the supervision of (had filed with) the SEC, would meet all SEC requirements for money market funds. Concerns have been raised that some external investment pools may have been reported as 2a7-like pools, despite not fully complying with the SEC requirements. The Board considered that the term *2a7-like* has been clearly defined in the *Comprehensive Implementation Guide*, but it determined that this criterion should be explicitly stated in category (a) guidance of the hierarchy of generally accepted accounting principles. The Board concluded that amending Statement 31 to explicitly indicate the intention of the 2a7-like provision would increase the visibility of these specific requirements and enhance financial reporting.

### **Interest Rate Risk Disclosures for Bond Mutual Funds**

18. Statement 40, paragraph 15, requires a disclosure of interest rate risk for “investments in mutual funds.” For bond mutual funds, these disclosures are readily available for those funds as a whole. On the other hand, for mutual funds that hold a mix of debt and equity securities, fund sponsors usually do not report interest rate risk metrics because interest rate risk does not apply to equity investments. A disclosure that focuses on the interest rate risk of these types of mutual funds would require “looking through” the mutual fund to those debt instruments. This look-through approach is not consistent with the intent of the Statement 40 requirement. Therefore, the Board concluded that an interest rate risk disclosure for mutual funds that hold a mix of debt and equity investments should not be required.

### **Contracts That Include Nonperformance Penalties**

19. Many governmental purchase and construction contracts include penalty provisions for nonperformance—liquidated damages. These nonperformance penalties have the potential to meet the definition of a derivative instrument as described in Statement 53, paragraphs 7–13. The Board discussed two types of nonperformance penalties—fixed and variable penalties. In the case of a fixed penalty, the payment does not vary according to changing market prices. That is, a fixed payment does not have a reference rate, limiting a government’s ability to participate in changing market prices. In the case of a variable penalty, the payment may vary according to changing market prices or some other reference rate. But the government’s ability to participate or realize payments based on changing market prices is contingent on the actions of the counterparty. In other words,

the ability to net settle through the nonperformance penalty is not available unless the counterparty defaults. This contingency, which is evident for both fixed and variable nonperformance penalties, distinguishes nonperformance penalties from payments that otherwise meet the net settlement criteria. The Board discussed both fixed and variable payment penalties and concluded that their inclusion in Statement 53 was not intended, and they should be excluded from the derivative instrument guidance.

### **Scope Exception for Certain Financial Guarantee Contracts**

20. Financial guarantees associated with debt a governmental investor holds as an investment are excluded from the original scope of Statement 53 because their value is based upon the occurrence or nonoccurrence of a discrete and identifiable event. Some of these guarantees are credit default swaps. On the other hand, financial guarantee contracts that provide payments based on a decline in credit quality are within the original scope of Statement 53. Therefore, some contracts may address credit events that are both within and outside of the scope of Statement 53. For example, a guarantee that protects the governmental debt investor from a failure to pay is excluded from the scope of Statement 53. That same contract, however, also may provide payment based upon negative changes in the debt issuer's credit rating, bringing the contract within the scope of Statement 53. The Board considered this possibility and concluded that there is the potential for a single contract to be divided between a fair value measurement basis and some other measurement basis. Further, these types of financial guarantees are frequently an element of investment portfolios. Excluding those financial guarantees from the scope of Statement 53 means that they will not be measured at fair value. The Board concluded that this exclusion presents the possibility of an investment portfolio that has some investments with similar characteristics measured at fair value and others not measured at fair value. Therefore, to enhance consistency in the application of the standard, the Board decided to eliminate the scope exception for certain financial guarantees.

21. Some governments use credit default swaps as a form of bond insurance. That is, the swap is associated with the government's debt, its premium is paid by the government, and its beneficiary is the debt holder, not the government. When this is the case, such a swap does not provide the governments with the possibility of receiving an insurance benefit. The Board concluded that these swaps are a form of insurance and, therefore, are outside the scope of Statement 53.

### **Scope Exception for Revenue-Based Contracts**

22. Some governments have entered into contracts that provide payments based upon specified volumes of sales or service revenues. An example of this is a lease payment, such as a concession agreement at a sports facility, which depends on a tenant's level of sales. Another example is a royalty payment, such as a patent or an oil well contract, which depends on the volume of an item's sales. Based on the original provisions of Statement 53, some of these contracts may meet the definition of a derivative instrument, which would place them within the scope of that standard. Statement 53 excludes contracts that are not exchange-traded (paragraph 17) but does not have a specific exclusion provision for revenue-based contracts. The Board considered these transactions

and concluded that the explicit exclusion of such contracts from the scope of Statement 53 is appropriate, because these contracts were not intended to be accounted for as derivative instruments.

### **Hybrid Instruments—Investor’s Initial Rate of Return**

23. Some financial instruments may consist of an embedded derivative instrument and a companion instrument. The Board considered circumstances in which the economic characteristics and risks of an embedded derivative instrument would not be considered closely related to the economic characteristics and risks of the companion instrument (paragraph 64). If any of these criteria in paragraph 64 are met, a hybrid instrument is present and the government should separately report the embedded derivative instrument and the companion contract. Since publication, it has come to the Board’s attention that one of the criteria—leveraged yield (paragraph 64c(5))—should be further clarified. The Board does not believe that the original provision in Statement 53 clearly articulates the intention that the holder’s initial rate of return on the companion instrument only has to have the *potential* for at least a doubled yield. Therefore, the Board concluded that Statement 53, paragraph 64c(5), should be amended.

## Appendix C

### AMENDMENTS TO EXISTING PRONOUNCEMENTS

24. National Council on Governmental Accounting Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, as amended by GASB Statements No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 3, and No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, paragraph 69, is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

a. Paragraph 9:

State and local governments are subject to many types of claims. Subject to the accounting and financial reporting distinctions of governmental funds, the criteria of FASB Statement No. 5, *Accounting for Contingencies*, should be the guidelines for recognizing a loss liability resulting from all claims that result from actions not included in the scope of Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*. Those claims include contractual actions, such as claims for delays or inadequate specifications on contracts,\* or for guarantees of the indebtedness of others ~~guarantees of the indebtedness of others~~ that are not derivative instruments, property tax appeals, and unemployment compensation claims. A loss liability for these claims should be recognized when information available prior to issuance of the financial statements indicates it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated.

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\*However, liability for the tort of another assumed by contract by a governmental entity or a public entity risk pool on behalf of a participating entity is included within the scope of this section. For example, a local government may agree *by contract* to assume the liability for another jurisdiction’s police officers in exchange for police services provided by that jurisdiction and not otherwise available to the governmental entity.

25. Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, is modified as follows:

a. Paragraph 24, Glossary:

Plan investments, whether equity or debt securities, real estate, or other investments ~~(excluding insurance contracts)~~, should be reported measured at ~~their~~ 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 there is not an active market for an investment but there is an active market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided that the expected cash flows are discounted at a rate commensurate with the risk involved. ~~Unallocated insurance contracts may be reported at contract value.~~ **Unallocated insurance contracts** should be excluded from plan assets. [Footnote references omitted.]

b. Paragraph 44, Glossary:

**Contract value**

~~The value of an unallocated contract that is determined by the insurance company in accordance with the terms of the contract.~~

**Insurance contract**

~~See Allocated insurance contract and Unallocated insurance contract.~~

**Unallocated insurance contract**

~~A contract with an insurance company under which payments to the insurance company are accumulated in an unallocated pool or pooled account (not allocated to specific members) to be used either directly or through the purchase of annuities to meet benefit payments when employees retire. Monies held by the insurance company under an unallocated contract may be withdrawn and otherwise invested.~~

26. Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, is modified as follows:

a. Paragraph 12:

Investment positions in 2a7-like pools should be determined by the pool's share price, each pool's net asset value per share established by the sponsors. A 2a7-like pool is an external investment pool that is not registered with the SEC as an investment company but operates in a manner that is compliant with the SEC's Rule 2a7 (17 Code of Federal Regulations §270.2a7). In other words, if the pool had registered with the SEC, the pool's daily activities would satisfy all SEC requirements of Rule 2a7.

b. Paragraph 22, Glossary

**2a7-like pool**

~~An external investment pool that is not registered with the SEC as an investment company, but nevertheless has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940 (17 Code of Federal Regulations §270.2a7). Rule 2a7 allows SEC-registered mutual funds to use amortized cost rather than market value to report net assets to compute share prices if certain conditions are met. Those conditions include restrictions on the types of investments held, restrictions on the term-to-maturity of individual investments and the dollar-weighted average of the portfolio, requirements for portfolio diversification, requirements for divestiture considerations in the event of security downgrades and defaults, and required actions if the market value of the portfolio deviates from amortized cost by a specified amount.~~

27. Statement No. 40, *Deposit and Investment Risk Disclosures*, is amended as follows:

a. Paragraph 15:

Interest rate risk information should be organized by investment type and amount using one of the following methods:

- a. **Segmented time distribution**
- b. **Specific identification**
- c. **Weighted average maturity**
- d. **Duration**
- e. **Simulation model.**

Governments are encouraged to select the disclosure method that is most consistent with the method they use to identify and manage interest rate risk. If a method requires an assumption regarding timing of cash flows (for example, whether an investment is or is not assumed to be called), interest rate changes, or other factors that affect interest rate risk information, that assumption should be disclosed. Governments with investments in bond mutual funds, external investment pools, or other pooled investments that do not meet the requirements definition of a 2a7-like pool should disclose interest rate risk information according to one of the methods above.

28. Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, is modified as follows:

a. Paragraph 22:

Plan investments, whether equity or debt securities, real estate, or other investments (~~excluding insurance contracts~~), should be ~~reported~~ measured at ~~their~~ 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 may be reported at contract value.~~ **Unallocated insurance contracts** should be excluded from plan assets. [Footnote references omitted.]

b. Paragraph 46, Glossary:

**Contract value**

~~The value of an unallocated contract that is determined by the insurance company in accordance with the terms of the contract.~~

**Insurance contract**

~~See Allocated insurance contract and Unallocated insurance contract.~~

**Unallocated insurance contract**

~~A contract with an insurance company under which payments to the insurance company are accumulated in an unallocated pool or pooled account (not allocated to specific members) to be used either directly or through the purchase of annuities to meet benefit payments when employees retire. Monies held by the insurance company under an unallocated contract may be withdrawn and otherwise invested.~~

29. Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, is modified as follows:

a. Paragraph 13:

A financial instrument or other contract meets the net settlement characteristic if its settlement provisions meet one of the following criteria:

a. Neither party is required to deliver an asset that is associated with the reference rate and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount) of the financial instrument. For example, most interest rate swaps do not require that either party deliver cash or interest-bearing

- assets with a principal amount equal to the notional amount of the contract.
- b. One of the parties is required to deliver an asset of the type described in paragraph 13a, but there is a market mechanism that facilitates net settlement. An example of that type of market mechanism is a futures exchange that offers a ready opportunity to enter into an offsetting contract.
  - c. One of the parties is required to deliver an asset of the type described in paragraph 13a, but that asset is readily convertible to cash or is itself a derivative instrument. An example of that type of contract is a **forward contract** that requires delivery of a bond. Another example is a **swaption**—an option to require delivery of a swap contract, which is a derivative instrument.

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.

- b. Paragraph 16:

~~*Certain financial guarantee contracts. Financial guarantee contracts that provide for payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the terms of a debt instrument are not included in the scope of this Statement. Financial guarantee contracts, however, that provide for payments to be made in response to changes in a reference rate are included in the scope of this Statement if they otherwise meet the definition of a derivative instrument. For example, a financial guarantee contract that provides for payments to be made if the credit rating of a debtor falls below a particular level is within the scope of this Statement.*~~ A financial guarantee contract—also known as a credit default swap—is excluded from the scope of this Statement if (a) a government pays the premium, (b) the swap is associated with the government’s debt, and (c) the debt holder is the beneficiary. Financial guarantee contracts, however, that meet the definition of a derivative instrument, but do not meet all three of the foregoing criteria, are within the scope of this Statement. Examples of financial guarantee contracts that are included in this Statement are contracts that provide for payment to be made:

- (1) To reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the terms of a debt instrument or violates a debt covenant
- (2) 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.

c. Paragraph 17:

*Certain contracts that are not exchange-traded.* A contract is not included in the scope of this Statement if the contract is not exchange-traded and its reference rate is based on one of the following:

- a. A climatic, geological, or other physical variable.
- b. A price or value of a nonfinancial asset. The nonfinancial asset should not be readily convertible to cash. For example, a government enters into a contract for the purchase of a fleet of vehicles. If either party to the contract fails to perform its obligations, the contract provides for liquidated damages as a percentage of the value of the vehicles. The liquidated damages provision is related to the acquisition of the seller's nonfinancial assets. Even though the contract meets the definition of a derivative instrument, it is not subject to the scope of this Statement.
- 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.

d. Paragraph 64, in part:

A hybrid instrument exists when the instrument meets all of the following criteria:

- c. The economic characteristics and risks of the derivative instrument are not closely related to the economic characteristics and risks of the companion instrument. This would be the case in any of the following circumstances:
  - (5) *Leveraged yield.* The yield of the companion instrument is leveraged. A leveraged yield occurs if the embedded derivative instrument meets both of the following criteria:
    - a. The holder's *initial* rate of return on the companion instrument ~~is at least doubled~~ has the potential for at least a doubled yield.
    - b. The rate of return is at least twice what the market return would be for an instrument with the same terms as the companion instrument.

## Appendix D

### CODIFICATION INSTRUCTIONS

30. Unless otherwise noted, the sections that follow update the June 30, 2008, *Codification of Governmental Accounting and Financial Reporting Standards*, for the effects of this Statement.

\* \* \*

#### CLAIMS AND JUDGMENTS

#### SECTION C50

.150 [Replace *guarantees of the indebtedness of others* with *guarantees of the indebtedness of others that are not derivative instruments*.] [NCGAS 4, ¶9, as amended by GASBS 10, ¶3, GASBS 34, ¶69, and GASBS XX, ¶7; NCGAS 4, ¶14]

\* \* \*

[*Note*: The changes in Section D40 update the Codification Instructions in Statement 53, paragraph 167.]

#### DERIVATIVE INSTRUMENTS

#### SECTION D40

Sources: [Add the following:] GASBS XX

.109 [Add the following to the end of the paragraph:] 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. [GASBS 53, ¶13; GASBS XX, ¶6]

.112 [Replace current paragraph with the following:] *Certain financial guarantee contracts*. A financial guarantee contract—also known as a credit default swap—is excluded from the scope of this Statement if (a) a government pays the premium, (b) the swap is associated with the government’s debt, and (c) the debt holder is the beneficiary. Financial guarantee contracts, however, that meet the definition of a derivative instrument, but do not meet all three of the foregoing criteria, are within the scope of this Statement. Examples of financial guarantee contracts that are included in this Statement are contracts that provide for payment to be made:

- (1) To reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the terms of a debt instrument or violates a debt covenant

- (2) 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.

[GASBS XX, ¶7]

.113 [Insert a new subparagraph c as follows:]

- 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.

[GASBS 53, ¶17; GASBS XX, ¶8]

.160 [Replace subparagraph c(5)(a) with the following:] The holder's *initial* rate of return on the companion instrument has the potential for at least a doubled yield. [GASBS 53, ¶64; GASBS XX, ¶9]

\* \* \*

## INVESTMENTS

## SECTION I50

Sources: [Add the following:] GASBS XX

.111 [Replace current paragraph .111 with the following:] Investment positions in 2a7-like pools should be determined by each pool's net asset value per share established by the sponsors. A 2a7-like pool is an external investment pool that is not registered with the SEC as an investment company but operates in a manner that is compliant with the SEC's Rule 2a7 (17 *Code of Federal Regulations* §270.2a7). In other words, if the pool had registered with the SEC, the pool's daily activities would satisfy all SEC requirements of Rule 2a7. [GASBS XX, ¶4]

.132 [Revise the last sentence as follows:] Governments with investments in bond mutual funds, external investment pools, or other pooled investments that do not meet the requirements of a 2a7-like pool should disclose interest rate risk information according to one of the methods above. [GASBS 40, ¶15; GASBS XX, ¶5]

[Delete current paragraph .559; renumber subsequent paragraphs.]

\* \* \*

**PENSION PLANS—DEFINED BENEFIT**

**SECTION Pe5**

Sources: [Add the following:] GASBS XX

.116 [Delete (*excluding insurance contracts*) from the first sentence; delete the penultimate sentence.] [GASBS 25, ¶24; GASBS 31, ¶4; GASBS XX, ¶3]

[Delete current paragraphs .520, .539, and .573; renumber subsequent paragraphs.]

\* \* \*

**POSTEMPLOYMENT BENEFIT PLANS  
OTHER THAN PENSION PLANS—DEFINED BENEFIT**

**SECTION Po50**

Sources: [Add the following:] GASBS XX

.118 [Delete (*excluding insurance contracts*) from the first sentence; delete the penultimate sentence.] [GASBS 31, ¶4; GASBS 43, ¶22; GASBS XX, ¶3]