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DEPARTMENT OF AUDIT
DIVISION OF MUNICIPAL AUDIT

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Division of Municipal Audit

MEMORANDUM

TO: Municipal Mayors and City Records

FROM: Dennis F. Dycus, CPA, CFE, Director
Division of Municipal Audit

SUBJECT: Impact of GASB Statement No. 53 on Municipalities that Have
Derivative Instruments: Municipal Governments Should Provide an
Independent Evaluation of Fair Value Calculations.

DATE: June 14, 2010

The purpose of this memorandum is to provide guidance to municipal governments that have derivative instruments requiring them to account for and make certain disclosures in accordance with Governmental Accounting Standards Board (GASB) Statement No. 53. This statement is effective for the year ending June 30, 2010. Therefore, this leaves a very short window of opportunity for municipal governments to prepare for implementation. **Paragraph four describes a new requirement for municipal governments, which will involve entering into a contract with an independent third-party derivative specialist.**

Derivative instruments are often complex financial arrangements used by municipal governments to manage specific risks. GASB Statement No. 53 requires that all derivative instruments be reported on the government-wide Statement of Net Assets at fair value. Previous to Statement No. 53, derivative instruments were not reported on the government-wide financial statements. Statement No. 53 describes the types of derivative instruments that fall within its scope and defines how fair value is calculated. Municipal governments that hold derivative instruments that meet the definition of *effective* hedging derivatives will be required to show the annual change in fair value of the instruments on the Statement of Net Assets. Municipal governments that hold *ineffective* hedging derivatives will reflect the annual change in fair value of derivative instruments on the Statement of Activities as investment revenue.

GASB Statement No. 53 provides guidance about acceptable methods of calculating fair value. Most municipal governments that currently hold derivative instruments also have a

financial adviser/derivative broker who determines fair value and provides additional information for financial statement note disclosures. Local governments will be responsible for determining that each derivative instrument meets the effectiveness test and is fairly valued using an approved calculation method. In most instances, this will require the services of an independent third-party investment/derivative specialist.

Local governments holding derivative instruments as of June 30, 2010 should obtain the services of a reputable third-party derivative specialist to evaluate whether each derivative instrument meets the effectiveness test and is fairly valued using an approved calculation method. The independent specialist should review the numbers and information prepared by the municipality's current financial advisor/derivative broker and report findings to the municipality and its auditors. Given the short time frame for implementation, this should occur as soon as possible. Auditors may have to qualify their opinion or issue an adverse opinion depending on the circumstances for each local government that is unable to verify the effectiveness and fair value of each derivative instrument based on an independent third-party evaluation.

The Division of Municipal Audit realizes the complexity of GASB Statement No. 53 and the difficulty local governments will have implementing the new standard. Feel free to contact us if you need assistance in understanding the requirements of Statement No. 53 or in locating a third party derivative specialist.

Municipal governments may contact the Municipal Technical Assistance Service (MTAS) for more information about GASB 53 or in locating a third party derivative specialist. A plain language summary of GASB Statement No. 53 can be obtained at <http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1175804831178> .

We have enclosed a list of derivative valuation companies who we understand have done valuations for local governments. **The Division of Municipal Audit does not recommend the listed companies. The Division of Municipal Audit does not vouch for the quality of services provided by the listed companies. The Division of Municipal Audit has not verified the accuracy of representations made by the listed companies.**

Enclosure

GASB 53
Derivative Valuation Specialist
Contact Information
Updated 6-29-10

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PFM Asset Management

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The Company has a Memphis Office, but this is the contact information we were presented.

DerivActiv

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Stonemont Financial Group

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