June 29, 2007

EXPOSURE DRAFT SUPPLEMENT

Proposed Statement of the Governmental Accounting Standards Board: Plain-Language Supplement

Accounting and Financial Reporting for Derivative Instruments

This plain-language supplement to an 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. 26-4

Comment Deadline: October 26, 2007

GASB

Governmental Accounting Standards Board
of the Financial Accounting Foundation

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Proposed Statement of the Governmental Accounting Standards Board: Plain-Language Supplement

Accounting and Financial Reporting for Derivative Instruments

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This document is a plain-language supplement to an Exposure Draft of a proposed Statement, *Accounting and Financial Reporting for Derivative Instruments*, issued by the Governmental Accounting Standards Board. This supplement is prepared for citizens, taxpayers, elected representatives, municipal analysts, and other external users of governmental financial information and uses a minimum of technical terminology. The supplement references the Exposure Draft and should be read in conjunction with it. The Exposure Draft can be downloaded from the same location as this supplement: www.gasb.org/exp/. Questions for users of governmental financial information and instructions for responding may be found on page 13.

OVERVIEW

The Governmental Accounting Standards Board (GASB) is proposing that the fair value of financial arrangements called "derivatives" or "derivative instruments" be reported in the financial statements of state and local governments. If a derivative effectively hedges (significantly reduces) an identified risk of losing cash flows or fair values, then its annual fair value changes would be deferred until the derivative ends or ceases to be effective. At that time, the accumulated changes, if any, would be reported as investment income or loss. The annual change in the fair value of other derivatives would be reported immediately as investment income or loss. The GASB also is proposing that additional information about derivatives be disclosed in the notes to the financial statements, including identification of the risks to which hedging derivative instruments themselves expose a government.

WHAT IS A DERIVATIVE?

A derivative is a unique and often complex financial arrangement that a government may enter into with another party, typically a private financial firm. The value of a derivative or the cash it provides to a government (or that it requires a government to pay) is based on changes in market prices, such as interest rates or commodity prices, in a separate transaction or agreement. In other words, the value or cash flows of a derivative derive from (are determined by) how market prices change in the separate transaction or agreement.

Governments enter into derivatives for at least four reasons:

- Governments often intend derivatives to be *hedges*. This type of derivative is an attempt to significantly reduce a specific financial risk that a government identifies, such as the risk of increasing costs.
- Some governments find that they can *lower their borrowing costs* by entering into a derivative in connection with debt they issue.
- Some governments engage in derivatives that are investments—governments are trying to *generate income,* as they would by buying U.S. Treasury bonds or depositing cash into a savings account.

- Some governments enter into derivatives to manage their cash flows. These derivatives may include an up-front cash payment to the government from the other party. The payment arrangements or terms of the derivative agreement essentially provide for the repayment of the up-front cash.

What Are Examples of Derivatives?

A simple example of a derivative is an *interest rate lock*—an agreement between a government and a lender that ensures the government will get a specific interest rate when it ultimately issues bonds or another form of debt. It is essentially the same as the rate lock that a person might obtain on a home mortgage. A government might enter into such an agreement if it believes interest rates will rise before it is ready to issue its debt.

A government that purchases significant quantities of a commodity, such as gasoline or heating oil, might enter into a derivative called a *futures contract* in order to protect itself against increases in the price of the commodity. Futures contracts are agreements to buy or sell a product for a specific price on a specific future date; they are traded actively in futures exchanges. A transit authority that needs to purchase fuel for its buses throughout the year, for example, might be concerned that fuel prices are going to rise. In June, the authority might purchase a futures contract for 420,000 gallons in September at $2.60 per gallon, the price the market expects the fuel to command in that month. The authority does not plan to buy the fuel covered by the contract (though it is entitled do so). Rather, it plans to use the contract to offset the higher prices when it actually does buy fuel in the future. If the price of fuel rises above $2.60 per gallon, the futures contract provides cash payments to the authority, offsetting the higher fuel price the authority has to pay. Essentially, the authority has converted the variable, uncertain price of fuel into a fixed, known price.

Interest Rate Swaps

One of the most common examples of a derivative entered into by a government—an interest rate swap—is related to debt issued by the government. Some governments have found that entering an interest rate swap and issuing variable-rate debt (bonds with an interest rate that rises and falls as market interest rates change) results in lower borrowing costs than if they had issued debt with a fixed interest rate without a derivative. A government issues variable-rate debt, for example, and also enters into a swap in which it agrees to pay a fixed interest rate to a financial firm, usually larger than the interest it currently pays on the variable-rate debt. In return, the firm agrees to pay the government an amount that is expected to offset the government's interest payments to the owners of the bonds—an amount that changes as market interest rates change.

Such a transaction is shown in Illustration 1, beginning on page 52 of the Exposure Draft. The government issues $100 million of variable-rate debt. At the same time, the government also enters into an interest rate swap in which it agrees to pay a fixed rate of 3.807 percent to a firm, in return for receiving a variable payment from the firm that is based on the Securities Industry and Financial Markets Association (SIFMA) swap index. (The SIFMA swap index tracks the prevailing rates on variable-rate debt issued by state and local governments.) The SIFMA-based payment from the firm is expected to roughly equal the interest payment the government is required to make to the bondholders. The ultimate effect of the swap is to "fix" the government's interest payment at 3.807 percent. This rate is intended to be a lower interest rate than the government could have obtained by issuing fixed-rate debt.

The payments on the derivative do not actually change hands—only the difference between the variable rate (the SIFMA swap index in the example above) and the fixed rate (3.807 percent) is paid. As long as the variable rate remains below 3.807 percent, the government's required payment is larger than the firm's, and the government pays the firm the difference. If interest rates rise above 3.807 percent, on the other hand, then the firm's required payment is larger than the government's, and the firm pays the difference to the government.

This kind of derivative is known as a "pay-fixed, receive-variable" swap. Governments sometimes enter into "pay-variable, receive-fixed" swaps in which they pay the firm an amount that varies with interest rates, while receiving a consistent amount from the firm. The side of a swap a government takes depends on what the government is trying to achieve; in this way, swaps offer significant flexibility.

Not only are the cash flows of an interest rate swap (payments to and from a government) determined by changes in the market interest rates but also the *value* of the derivative. Unless cash changes hands when the hedge is first entered into, it begins with a zero value. The value of the swap changes as interest rates rise or fall. If interest rates were to drop after a government entered into a swap like the one described above, then the value of the swap would grow. In fact, the swap would have a growing *negative* value from the government's perspective, representing a liability—an amount the government would have had to pay the firm if the swap had been terminated at that time. The value of the swap in Illustration 1 grows to negative $4.8 million as the SIFMA swap index declines in the first 2 years. If the SIFMA swap index had risen, the swap's value also would have grown, but *positively* from the government's perspective, representing an asset—an amount the government would have been paid by the firm if the swap had been terminated at that point.

What Does the GASB Consider to Be a Derivative?

The definition of what constitutes a derivative may vary depending upon whom you ask. The GASB is proposing that its accounting and financial reporting standards for derivatives apply to *financial arrangements with values or cash payments that are based on what happens in separate transactions, agreements, or rates,* and that have these characteristics:

- *The financial arrangements are leveraged.* This means they require minimal or no initial investment on the part of a government but nevertheless achieve changes in fair value that would have required a far larger initial investment.
- *The financial arrangements can be settled early* with a cash payment or the transfer of an equivalent asset.

WHY IS THE GASB SETTING ACCOUNTING AND REPORTING STANDARDS FOR DERIVATIVES?

The number and dollar amount of derivatives entered into by governments is substantial and growing rapidly. The complexity and variety of derivatives also are increasing significantly.

Risks Posed by Derivatives

Although a government may enter into a derivative in order to minimize an identified risk, the derivative itself could expose a government to risks it otherwise would not have faced. *Credit risk,* for instance, is the chance that the firm (the counterparty) will not make good on its promise to pay the government. The longer a derivative lasts, the greater the risk to a government that changes in interest rates could reduce the value of the transaction to the government; this is called *interest rate risk.* The possibility that a derivative may end earlier than expected, thus depriving a government of the protection from risk and potentially requiring it to make a significant termination payment, is known as *termination risk.*

In some derivatives, the amount received by the government from the firm is based on one market rate and the amount the government pays to its bondholders is based on a different rate. For instance, one may be based on the SIFMA swap index, while the other is based on a percentage of the London Interbank Offered Rate (LIBOR). If the rate determining the firm's payments to the government decreases more than the rate determining the government's payments to the bondholders, then the government will receive less from the firm than it has to pay out to the bondholders. The possibility that this may occur is *basis risk.*

Rollover risk exists when the derivative does not last as long as the associated debt is outstanding. For instance, an interest rate swap might have a 10-year term, but the variable-rate debt matures in 30 years. Consequently, after the derivative ends, the government no longer is protected against rising interest rates and may not be able to enter into a new derivative with similar terms. *Market-access risk* is the chance that a government will not be able to issue debt (for example, in a bond refunding) or that doing so will become more expensive. Finally, *foreign currency ri*sk is the possibility that changes in exchange rates will adversely affect the value of a derivative.

The GASB's Project on Derivatives

The GASB has been working to set standards for the accounting and reporting of derivatives because the public needs more information about these transactions. The risk of the loss of cash flows, for instance, is important to a state legislator or city council member trying to identify what resources will be available to fund programs, or to a taxpayer association concerned that taxes would have to be raised to cover the loss, or to a municipal bond analyst evaluating a government's ability to make its debt service payments when they come due.

To evaluate the risks that derivatives potentially pose to the financial health of governments, the public needs to understand the nature of these transactions, how their values and cash flows change over time, and their inherent risks. Although current standards require governments to disclose information about their derivatives in the notes to the financial statements, few derivatives are reported in the financial statements themselves.

The GASB has conducted research on derivatives and deliberated possible standards for several years. In April 2006, the GASB issued a Preliminary Views document that laid out initial ideas about how to account for and report derivatives, identified related issues, and sought public feedback. In addition to receiving over 90 comment letters in response to the Preliminary Views, the GASB conducted two public hearings, two panel discussions that brought together constituents from different perspectives, and a roundtable discussion for external financial statement users. Over the past year, the GASB has been analyzing the input it received and reconsidering the preliminary approach outlined in the Preliminary Views based on what it has heard.

The Exposure Draft that this supplement accompanies incorporates many of the recommendations made in response to the Preliminary Views. The Exposure Draft proposes new standards for accounting for and reporting derivatives and explains the reasoning behind the proposals. The GASB is seeking feedback from the public regarding the appropriateness of these proposals and the usefulness of the information that would result if governments implemented them.

WHAT IS THE GASB PROPOSING?

The GASB is proposing that the fair value of derivatives be reported in the financial statements. Fair value is either the price an item is expected to garner if sold on the open market between two unrelated willing parties or the value of future cash flows in today's dollars. One type of derivative, a synthetic guaranteed investment contract, would be reported at contract value instead of fair value. Governments also would be required to disclose information about their derivatives in the notes to the financial statements.

What Information Would Be Reported about Derivatives in the Financial Statements?

In general, the fair value of a derivative as of the end of the fiscal year covered by the financial statements would be reported in the balance sheets (such as the statement of net assets). However, the annual changes in the fair value of a *hedging derivative instrument* would be *deferred*—reported as deferred inflows and deferred outflows on the balance sheets. A hedging derivative instrument significantly reduces financial risk by substantially offsetting the changes in cash flows or fair values of the item the derivative is associated with. (For more about the characteristics of a hedging derivative instrument, see the section on page 8 about how to identify a hedging derivative instrument.)

Deferral of changes in fair value would last until the derivative ends or the hedge ceases to be effective (that is, to significantly reduce risk), at which time the accumulated gains or losses, if any, would be reported as investment income or loss in the change statements (such as the statement of revenues, expenditures, and changes in fund balances). For other derivatives, the increase or decrease in fair value would be reported immediately as investment income or loss, respectively.

What Information Would Be Disclosed about Derivatives in the Notes to the Financial Statements?

The Exposure Draft would require a note disclosure that includes summary information about a government's derivatives. The government's derivatives would be divided among those related to the government's governmental activities, its business-type activities, and its fiduciary funds. Within each of those three groups, the derivatives would be sorted into (1) hedging derivative instruments (distinguishing between fair value hedges and cash flow hedges) and (2) investment derivative instruments. Individual derivative instruments would be totaled by type under those categories, and the following information would be presented about them (see the example on page 143 of the Exposure Draft):

- Notional amount (that is, the amount—stated in dollars, shares, gallons, and so on—on which payments depend)
- Fair value as of the date of the financial statements and the locations in the financial statements where it is reported (this disclosure will be helpful because the amounts disclosed in the notes are aggregated in the financial statements)
- Changes in fair value during the year and the locations in the financial statements where those changes are reported
- The fair value of derivatives that were reclassified from a hedging derivative instrument to an investment derivative instrument during the year because they no longer substantially offset changes in cash flows or fair values
- The amount removed from the deferred inflows and outflows in the balance sheets and reported as investment income or loss during the year (for instance, because a derivative ended).

Information about Hedging Derivative Instruments

Governments would provide additional information about their hedging derivative instruments. Although governments would be allowed to aggregate their hedging derivative instruments, the differences in the terms of the derivatives may lead to this information being disclosed individually for many of them. The information would include:

- An explanation of a government's objective for entering into the hedging derivative instrument and how it planned to achieve that objective
- Significant terms of the derivative, such as:
    - Notional amount

    - The indexes or interest rates it is based on, including any limitations on the impact that changes in the indexes or rates can have on the derivative
    - Options embedded in the derivative
    - Starting and ending dates
    - The amount of cash that changed hands, if any, when the derivative was initiated
- If the item being hedged is debt, then the government would disclose the net cash flows of the hedging derivative (see page 147 of the Exposure Draft)
- The risks to which the derivative exposes the government (see pages 145 and 146 of the Exposure Draft):
    - Termination risk—a government discloses any terminations that occurred during the year, dates that its remaining derivatives may be terminated, and unusual provisions for termination
    - Credit risk—if a derivative exposes it to credit risk, a government reports:
        - The credit quality rating of the firm
        - The maximum potential loss if the firm fails to fulfill its obligations
        - The collateral or other security supporting the derivatives
        - Significant concentrations of credit risk with a particular firm or group of firms
    - Interest rate risk—a government describes the terms of its derivatives that increase its exposure to interest rate risk
    - Basis risk—a government discloses the derivative's payment terms and any payment terms of the associated debt
    - Rollover risk—a government discloses the maturity of the derivative and the subsequent maturity of the associated debt
    - Market-access risk—a government indicates if it is exposed to the risk of being unable to borrow
    - Foreign currency risk—a government discloses the U.S. dollar balances of derivatives that expose it to foreign currency risk, organized by type of currency and type of derivative.

Disclosures for Investment Derivative Instruments

For derivatives that are investments, governments would disclose the credit risk information described above (as well as include those derivatives in the summary information disclosure). Otherwise, governments would apply the disclosure requirements for investments set forth in GASB Statement No. 40, *Deposit and Investment Risk Disclosures*. Hedging derivative instruments that no longer substantially offset changes in cash flows or fair values also would be disclosed following the provisions of Statement 40.

Contingent Liabilities

Governments also would disclose any contingent liabilities included in their derivatives. A contingent liability is a possible future liability that would arise if certain conditions occur. An example is a requirement that a government post collateral if its credit rating declines. A government with a derivative containing a contingent liability would present a note disclosure including:

- A description of the contingency and the circumstances that would trigger it
- The total fair value of all derivatives containing contingent liabilities
- The total amount the government would have to post as collateral if the triggering circumstances occurred
- Any amounts posted as collateral by the government during the year.

How Would a Government Identify and Report a Hedging Derivative Instrument?

For a derivative to be considered a hedging derivative instrument, it would have to be (1) associated with an item that is eligible to be hedged and (2) determined to be *effective.*

Items eligible to be hedged are reported in the financial statements using a measurement other than fair value. They could be a single asset or liability, a group of similar assets or liabilities, or a specific expected exchange of resources in the future that exposes a government to a risk of losing cash flows or fair value. An example of a “hedgeable” item is variable-rate debt, which exposes a government to the risk of increasing interest rates and therefore larger interest payments to the bondholders. On the other hand, investments generally are not considered hedgeable for financial reporting purposes because they are already reported at fair value in the financial statements, and changes in their fair value already run through the change statements. For the purposes of these proposed standards, a derivative associated with a hedgeable item is known as a *potential hedging derivative instrument.*

A hedging derivative instrument is a potential hedging derivative instrument that is effective. *Effective* means that the derivative significantly reduces an identified financial risk by providing changes in fair values or cash flows that substantially offset the changes in fair values or cash flows of the associated item being hedged. As noted above, the changes in fair value of a hedging derivative instrument would be reported in the balance sheet or similar financial statement as deferred inflows (accumulated increases in fair value) or deferred outflows (accumulated decreases in fair value), rather than being reported as investment income or loss in a government’s change statements. Each year’s change in fair value would be added to the deferrals in the balance sheets. If the hedging derivative instrument remains effective and continues until its planned conclusion, the deferrals will balance out the value of the derivative until that value declines to zero when it concludes.

For the interest rate swap in Illustration 1 (page 52 of the Exposure Draft), the fair value of $2,984,833 is reported on the liability side of the balance sheets as of June 30, 20X1, and the decrease in fair value is reported as a deferred outflow of $2,984,833 on the asset side. (See page 58 of the Exposure Draft.) The amount by which the government’s payment exceeded the firm’s—$2,117,846—is reported as interest expense or expenditure, in addition to the interest paid or due to the holders of the variable-rate debt. (If the firm’s required payment exceeded that of the government’s, however, the difference would have offset a portion of the interest expense or expenditure related to the variable-rate debt.) In the financial statements for the fiscal year that ended on June 30, 20X2, the balance sheets include the swap at a fair value of negative $4,786,631, and the decrease in fair value of $1,801,798 is added to the deferred outflow account (for a total of $4,786,631).

A Hedging Derivative Instrument That Ends Early or Ceases to Be Effective

If a hedging derivative instrument is terminated prior to its expected ending date or ceases to be effective, the accumulated deferrals would be removed from the balance sheets and reported as investment income or loss in the change statements. If a hedging derivative instrument is associated with an expected future exchange of resources that is no longer probable to occur, then the accumulated deferrals also would be reported immediately in the change statements.

The swap in Illustration 1 ends when planned and remains effective throughout the period of the hedging derivative instrument. The value of the swap declines to zero when it concludes and there is no income or loss. However, when a hedging derivative instrument ends early or ceases to be effective, the accumulated deferrals from prior years would be reported as investment income or loss, plus or minus the changes in fair value for that year. Illustration 4 (beginning on page 76 of the Exposure Draft) depicts a derivative that ceases to be effective during the fiscal year that ended on June 30, 20X3. The financial statements for 20X3 report the accumulated deferred charges as of the end of fiscal year 2003—$4,000,154—less the increase in the derivative's fair value in 2004—$2,463,868—as an investment loss. In other words, $1,536,286 is deducted from the amount reported as investment income in the change statements.

Once a hedging derivative instrument is no longer effective (that is, when it no longer falls within the parameters described below and therefore is no longer substantially offsetting changes in fair values or cash flows), the deferral of fair value changes would cease. Thereafter, annual changes in fair value would be reported in the change statements as investment income or loss. The fair value of the derivative in Illustration 4 increases by $1,536,286 in fiscal year 20X4, and that amount is reported as investment income.

How Is the Effectiveness of a Potential Hedging Derivative Instrument Evaluated?

As of the end of each period for which governments prepare financial statements (typically, the end of the fiscal year), the GASB proposal would require them to evaluate the effectiveness of each potential hedging derivative instrument established during the period. Effective hedging derivatives would be reevaluated as of the end of each succeeding fiscal year to determine if they remain effective. Governments would be allowed to use two types of approaches to evaluating effectiveness—consistent critical terms or quantitative methods. (Appendix D of the Exposure Draft includes flowcharts that lay out the steps involved in evaluating effectiveness.)

Consistent Critical Terms

If the critical terms of the potential hedging derivative instrument and the terms of the item it is hedging are the same—for instance, the ending date of an interest rate swap is the same as the maturity date of the bonds, both are based on the SIFMA swap index, and so on—then the potential hedging derivative instrument is presumed to be effective.

Under such circumstances, any change in the cash flows or fair value of the item being hedged is offset by changes in the cash flows or fair value of the potential hedging derivative. If a government uses the consistent critical terms method and finds that the potential hedging derivative instrument does not have critical terms that are consistent with the hedged item, then it would evaluate it again using one or more quantitative methods.

Quantitative Methods

The Exposure Draft identifies three quantitative methods that may be used for evaluating effectiveness—synthetic instruments, dollar-offset, and regression analysis. These methods measure the degree to which the changes in the fair value or cash flows of the potential hedging derivative instrument offset those of the item being hedged. The Exposure Draft also allows for other acceptable quantitative methods that meet qualifying criteria to be employed. A potential hedging derivative that is not determined to be effective using one of the quantitative methods may be reevaluated using another method.

Synthetic Instrument Method

A synthetic instrument is the combination of an item being hedged and a potential hedging derivative instrument to create a theoretical instrument. The synthetic instrument method involves the calculation of an interest rate (or commodity rate, as appropriate) for the synthetic instrument based on the actual experience following the start of the hedge. The synthetic rate is then compared with the fixed-rate portion of the derivative.

If the synthetic rate is no less than 90 percent and no greater than 111 percent of the fixed rate as of the date of the financial statements, then the fair values or cash flows of the potential hedging derivative instrument substantially offset those of the item being hedged. Therefore, the potential hedging derivative instrument is considered effective for financial reporting purposes and is treated as a hedging derivative instrument. If the synthetic rate is outside that range, a government would examine the rates over the life of the derivative thus far. If the synthetic rate over that period falls within the 90 to 111 percent range, then the potential hedging derivative instrument is considered effective for financial reporting purposes. However, even if the synthetic rate as of the date of the financial statements or over the life of the derivative thus far falls within the range, a government may yet determine that the hedge is not effective for financial reporting purposes because new conditions in the market, such as a change in tax rates, make it unlikely that the hedging derivative instrument will remain effective going forward.

Dollar-Offset Method

The dollar-offset method divides changes in the fair values or cash flows of the hedged item with those of the potential hedging derivative instrument, or vice versa. As long as the result of this calculation falls within a range of 80 to 125 percent, the changes in fair values or cash flows substantially offset and the potential hedging derivative instrument is considered effective for financial reporting purposes. Like the synthetic instrument method, the dollar-offset method can be applied to the period covered by the financial statements or over the life of the derivative.

Regression Analysis

Regression analysis examines the statistical relationship between changes in the fair values or cash flows of a hedged item and its associated potential hedging derivative. For a potential hedging derivative instrument evaluated using regression analysis to be considered effective for financial reporting purposes, the analysis should produce:

- An R-squared of at least 0.80
- An F-statistic that indicates statistical significance at the 95 percent confidence level
- A regression coefficient for the slope between –1.25 and –0.80.

Other Quantitative Methods

Governments would be allowed to employ other generally utilized quantitative methods for evaluating effectiveness that are based on established principles of financial economic theory. Those methods also would have to be able to demonstrate that the changes in cash flows or fair values of a potential hedging derivative instrument substantially offset the changes in cash flows or fair values of the hedged item.

How Would Derivatives with Up-Front Payments Be Reported?

When a firm makes a cash payment to a government at the start of a derivative, it expects to recoup that payment—it is essentially a loan. The terms of the derivative will incorporate the repayment of the up-front cash payment, perhaps by requiring payments to the firm based on a fixed rate that is greater than prevailing market rates (referred to as "off-market" rates). Such a derivative would be considered a *hybrid instrument*—the combination of a derivative and a "companion" instrument that is not reported at fair value in the financial statements, such as a debt issuance. The Exposure Draft would require governments to report the derivative portion of a hybrid instrument separately from the companion instrument in the financial statements. Therefore, governments receiving cash from a firm when entering a derivative would report a liability on the balance sheets equal to the cash they received; the remainder of the transaction—the actual derivative—would be subject to the reporting requirements discussed above. Each year while the derivative is in place, a portion of the government's payments to the firm would be reported in the financial statements as a repayment that reduces the outstanding liability in the balance sheets. In Illustration 5, beginning on page 85 of the Exposure Draft, you can see that the government is reporting annual debt service expenditures ($627,890) and interest expenses ($115,558) related to the repayment of the cash provided by the firm.

HOW ARE THESE PROPOSED STANDARDS DIFFERENT FROM THE PROPOSALS IN THE PRELIMINARY VIEWS?

The basic reporting requirements laid out in the Preliminary Views document have been retained—derivatives would be reported at fair value in the balance sheets, and the change in fair value would be reported as investment income or loss in the change statements, except for hedging derivative instruments, in which case fair value changes would be deferred until the derivative ends or ceases to be effective. However, the GASB did make several notable changes to its original proposals based on the public feedback it received and further study.

- In the Preliminary Views, for a derivative to be considered a hedging derivative instrument, a government's declared objective for entering into the derivative would have had to be hedging a specific risk. Because of difficulties that could be encountered in documenting a government's objective—and therefore the possibility that otherwise eligible derivatives would be disqualified because proper documentation was not available—that requirement was dropped. However, the disclosure of the government's objective is still proposed to be carried forward.
- In addition to the quantitative methods for evaluating the effectiveness of potential hedging derivative instruments identified in the Preliminary Views, governments would be allowed to use other quantitative methods that meet certain qualifying criteria.
- One type of derivative—synthetic guaranteed instrument contracts (SGICs)—would be reported at contract value, rather than fair value. This is consistent with the fact that annual gains and losses on SGICs are not immediately recognized but are spread over the remaining life of the investments that underlie them.
- Rather than applying a single set of disclosure requirements to all derivatives, as proposed in the Preliminary Views, governments would instead disclose investment derivatives following the same standards applied to other investments.
- The proposed note disclosure of basic summary information has been simplified. Initially, the GASB had proposed requiring information about how the fair value of each individual derivative changed during the year. The Exposure Draft would allow governments to aggregate derivatives by type, though it also requires that they be divided among categories of derivatives—cash flow hedges, fair value hedges, and investments—and presented according to whether they are associated with governmental activities, business-type activities, or fiduciary funds. Additional disclosures for hedging derivatives also could be made for groups of derivatives in the aggregate. However, differences in the terms of the derivatives would likely lead to the additional information being disclosed individually for many of them.
- Proposed disclosures of information about the methods a government used to evaluate the effectiveness of its potential hedging derivative instruments and the results of the evaluation are eliminated. (Governments that use a qualifying method other than those in the Exposure Draft would, however, disclose the identity and characteristics of that method and the results of evaluations using it.) Also eliminated is a proposed requirement to calculate and disclose the amount of ineffectiveness in hedging derivatives that are determined to be effective using one of the quantitative methods.
- Disclosures are added relating to contingent liabilities contained in derivatives and to SGICs.

WHAT INFORMATION DOES THE GASB NEED TO PROCEED WITH THIS PROJECT?

When the GASB sets standards, a crucial part of its “due process” activities is the publication of proposals for public discussion and comment. The GASB relies on the comments of the people who prepare and audit financial statements to assess the technical accuracy and appropriateness of its proposals. The GASB often poses questions regarding critical issues in its proposed standards.

The users of financial statements, on the other hand, are in the best position to help the GASB understand whether or not the information to be provided by its proposals is useful for fulfilling their need for governmental financial information. The substance of the comments from each of the GASB’s constituents is more important to the GASB’s deliberations than the total number of people for or against a certain proposal. An Exposure Draft is not an opinion poll, and the GASB’s ultimate decisions are not necessarily those with the most popular support.

You can help the GASB to complete this project by reviewing the proposal with the following questions in mind:

1. How would the information about derivatives required by the Exposure Draft be useful to your work, the decisions you make, or the research you conduct? If it would not be useful to you, why would it not be relevant?
2. The GASB made several changes to the disclosure requirements first proposed in the Preliminary Views. (See pages 11 and 12 of this supplement.) How have these changes improved or reduced the usefulness of the information? (Please be as specific as possible.)
3. How could the proposed requirements be improved to provide information that is more useful to you?

HOW CAN YOU SHARE YOUR OPINIONS WITH THE GASB?

There are two general ways to provide feedback to the GASB—submitting written comments and participating in GASB public hearings and forums. In either case, it is essential to the Board to receive feedback from you that answers the questions presented above. You may also wish to address other issues raised in the Exposure Draft.

If you would like to submit written comments to the GASB about these proposals, there are three ways you may do so:

- Internet-based questionnaire—your comments can be entered and submitted electronically using a questionnaire that can be found at http://www.gasb.org/survey/cgi-bin/dpls2.html
- By email—send your comments to director@gasb.org
- By traditional mail—complete the form at the end of this supplement or include your comments in a letter and mail to:

Director of Research and Technical Activities
Project No. 26-4
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Submissions are requested by October 26, 2007.

On November 1, 2007, the GASB is holding a public hearing and a roundtable for financial statement users at the New York City Office of Management and Budget, 75 Park Place, 8th Floor, Rooms S1 and S2, New York. The roundtable will begin at 9:00 a.m. and the public hearing at 11:00 a.m. The roundtable is an opportunity for external users of governmental financial information (analysts in the financial community, elected representatives, members of the press, taxpayer groups, citizens, and so on) to provide input in an open discussion with one another.

If you wish to speak at the hearing, you should notify the GASB of your intent in writing and submit a copy of your comments, using the address above, no later than October 12. You can testify in person or via telephone. Please read the participation requirements in the notice of public hearing in the Exposure Draft.

If you wish to participate in the user roundtable, written comments are not required, but you need to notify the GASB of your intent. Observers are welcome at the hearings and roundtable. You can register to participate in or observe the roundtable by submitting your name and affiliation to Ragan Vincent at 203-956-5372 or rpvincent@gasb.org no later than October 26.

WHAT IS THE PURPOSE OF THIS SUPPLEMENT?

To help achieve its mission of setting accounting standards that result in information that is useful for making decisions, the GASB is taking steps to communicate with the public in a more understandable and broadly accessible manner. In particular, the GASB occasionally uses "plain-language" supplements in conjunction with its due process documents (the publications it releases to obtain feedback on proposed changes to governmental accounting and financial reporting standards).

This document is a plain-language supplement that accompanies an Exposure Draft containing proposed changes to the information that state and local governments are required to report about derivatives transactions—*Accounting and Financial Reporting for Derivative Instruments.* The intention of this plain-language supplement is to make it easier for you to participate knowledgeably in the GASB's standards-setting activities. The supplement attempts to achieve this goal by (1) presenting the proposals with as little of the Exposure Draft's technical and implementation-oriented vocabulary as possible and (2) focusing on the impact the proposals will have on the information you will find in government financial statements. This supplement focuses on the information that most typically would result from the proposed new standards and does not address certain circumstances that are less common. The complete details of the proposals can be found in the Exposure Draft, which more fully explains the GASB's specific proposals and its reasons for making them.

The GASB hopes that, as a result of its efforts to present its proposed standards in less technical language, more users of governmental financial information will comment on its proposals. The GASB will consider this feedback, and that expressed in the public hearing and user roundtable, during its deliberations prior to releasing final accounting and financial reporting standards for derivatives.

WHAT IS THE GASB?

The GASB is the private, nonpartisan, nonprofit organization that is recognized as the setter of the standards that U.S. state and local governments follow when accounting for their finances and reporting them to the public. The GASB was founded in 1984 under the auspices of the Financial Accounting Foundation (FAF), which appoints the GASB's Board, raises its funds, and oversees its activities. The FAF also oversees the Financial Accounting Standards Board, which establishes standards for the private sector and not-for-profit organizations. The mission of the GASB is to establish and improve standards of state and local governmental accounting and financial reporting that will:

- Result in useful information for users of financial reports, and
- Guide and educate the public, including issuers, auditors, and users of those financial reports.

Although the GASB does not have the power to enforce compliance with the standards it promulgates, the authority for its standards is recognized under the Code of Professional Conduct of the American Institute of Certified Public Accountants. The Code requires auditors to note any departures from GASB standards when they express an opinion on financial reports that are presented in conformity with generally accepted accounting principles. Also, legislation in many states requires compliance with GASB standards, and governments usually are expected to prepare financial statements according to those standards when they issue bonds or notes or otherwise borrow from public credit markets.

The GASB is composed of a full-time chair and six part-time members drawn from various parts of the GASB's constituency—state and local government finance officers, auditors, the accounting profession, academia, and persons who use financial statement information. The GASB has a professional staff drawn from similar constituencies as the Board. The staff works directly with the Board and its task forces, conducts research, analyzes oral and written comments received from the public, and drafts documents for consideration by the Board.

HOW DOES THE GASB SET STANDARDS?

The GASB follows the set of "due process" activities enumerated in its published rules of procedure before issuing its standards. Due process is stringent and is designed to permit timely, thorough, and open study of financial accounting and reporting issues by the preparers, attestors, and users of financial reports in order to encourage broad public participation in the standards-setting process.

For many issues it addresses, the GASB:

- Appoints an advisory task force of outside experts
- Studies existing literature on the subject and conducts or commissions additional research if necessary
- Publishes for public comment a discussion document setting forth the issues and possible solutions
- Conducts public hearings and forums
- Broadly distributes an Exposure Draft of a proposed standard for public comment.

Significant steps in the process are announced publicly. The GASB's meetings are open to public observation and a public record is maintained. The GASB also is advised by the Governmental Accounting Standards Advisory Council, a 29-member group appointed by the FAF and representing a wide range of the GASB's constituents.

Additional information about the GASB and its activities may be found at www.gasb.org.

FINANCIAL STATEMENT USER RESPONSE FORM

Please complete this form and submit it to the GASB at the address listed on page 14 of this supplement. (Use additional pages if necessary.) Alternatively, you can submit your comments by using the Internet questionnaire at http://www.gasb.org/survey/cgi-bin/dpls2.html or via email to director@gasb.org.

Name (required)	______________________________
Title	______________________________
Organization (required)	______________________________
Address (required)	______________________________
Address	______________________________
City, state, zip (required)	______________________________
Email	______________________________
Telephone	______________________________

1. How would the information about derivatives required by the Exposure Draft be useful to your work, the decisions you make, or the research you conduct? If it would not be useful to you, why would it not be relevant?

2. The GASB made several changes to the disclosure requirements first proposed in the Preliminary Views. (See pages 11 and 12 of this supplement.) How have these changes improved or reduced the usefulness of the information? (Please be as specific as possible.)

3. How could the proposed requirements be improved to provide information that is more useful to you?

THANK YOU!
Please return to:
GASB
Director of Research and Technical Activities
Project 26-4
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116