

April 28, 2006

PRELIMINARY VIEWS SUPPLEMENT

Preliminary Views
of the Governmental
Accounting Standards Board:
Plain-Language Supplement

Accounting and Financial Reporting for Derivatives

This plain-language supplement to
a Preliminary Views document
is issued by the Board for public comment.
Written comments should be addressed to:

Director of Research and Technical Activities
Project No. 26-4P

Comment Deadline: July 28, 2006



Governmental Accounting Standards Board
of the Financial Accounting Foundation

To order additional copies of this supplement (Product Code No. GV09S) or copies of the full Preliminary Views (Product Code No. GV09, contact the GASB Order Department at 1-800-748-0659, or order online at www.gasb.org.

Copyright © 2006 by Governmental Accounting Standards Board. All rights reserved. Permission is granted to make copies of this work provided that such copies are for personal or intraorganizational use only and are not sold or disseminated and provided further that each copy bears the following credit line: “Copyright © 2006 by Governmental Accounting Standards Board. All rights reserved. Used by permission.”

Preliminary Views of the Governmental Accounting Standards Board:

Plain-Language Supplement

Accounting and Financial Reporting for Derivatives

April 28, 2006

CONTENTS

	Page Number
What Is a Derivative?	1
What Are Examples of Derivatives?	1
What Does the GASB Consider to Be a Derivative?	3
Why Is the GASB Setting Accounting and Reporting Standards for Derivatives?	3
What Is the GASB Proposing?	4
What Information Would Be Reported about Derivatives in the Financial Statements?	4
How Would a Government Identify and Report a Hedge?	4
A Hedge That Ends Early or Becomes Ineffective	5
How Would a Government Determine If a Hedge is Effective?	6
Consistent Critical Terms	6
Synthetic Instruments.....	6
Quantitative Techniques	7
What Information Would Be Disclosed about Derivatives in the Notes to the Financial Statements?	7
Hedge Ineffectiveness.....	8
Derivatives Activity during the Year	8
How Would Derivatives with Up-Front Payments Be Reported?	9
What Information Does the GASB Need to Proceed with This Project?	9
How Can You Share Your Opinions with the GASB?	10
What Is the Purpose of This Supplement?	11
What Is the GASB?.....	12
How Does the GASB Set Standards?	12
Response Form	15

This document is a plain-language supplement to a Preliminary Views (PV) document, *Accounting and Financial Reporting for Derivatives*, issued by the Governmental Accounting Standards Board (GASB). This supplement is prepared for citizens, taxpayers, elected representatives, municipal analysts, and other external users of governmental financial information and therefore uses a minimum of technical terminology. The supplement references the PV and should be read in conjunction with it. The PV can be downloaded from the same location as this supplement: www.gasb.org/exp/. Questions for users of governmental financial information are posed on page 10 and instructions for responding may be found on pages 10 and 11.

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 what happens in a separate transaction or agreement, such as an investment or bonds issued by the government. In other words, the value or cash flows of a derivative *derive* from (are determined by) how the separate transaction performs or from the terms of the separate transaction or agreement.

Governments enter into derivatives for at least four reasons:

- Some derivatives that governments engage in are essentially 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 include an up-front cash payment to the government from the other party. The payment arrangements or terms of the derivative agreement provide for the repayment of the up-front cash.
- Some governments find that they can *lower their borrowing costs* by entering a derivative in connection with debt they issue.
- Governments often intend derivatives to be *hedges*. A hedging derivative is an attempt to reduce specific financial risks that a government perceives, such as the risk of increasing costs or the risk of losing expected cash flows.

What Are Examples of Derivatives?

A simple example of a derivative that is a hedge is an *interest rate lock*—an agreement between a government and a lender that 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 believed interest rates would rise before it was 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. The authority might purchase a futures contract for 42,000 gallons in July 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 to 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, the value of the futures contract increases simultaneously, thereby 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.

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 issuing variable-rate debt (bonds with an interest rate that rises and falls as market interest rates change) and entering an interest rate swap 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 and also enters into a swap in which it agrees to pay a steady 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 on page 41 of the PV. The government issues \$100 million of variable-rate debt based on The Bond Market Association Municipal Swap Index (BMA). (BMA tracks the prevailing rates on variable-rate debt issued by state and local governments.) At the same time, the government also enters into an interest rate swap in which it agrees to pay a fixed 3.805 percent rate to a firm, in return for receiving a variable payment from the firm that is based on BMA and therefore is expected to equal the interest payment the government is required to make to the bondholders (which was 2.68 percent at the time the debt was issued). The ultimate effect of the swap is to “fix” the government's interest payment at 3.805 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 (BMA in the example above) and the fixed rate (3.805 percent) is paid. If interest rates go down, then the government's required payment is larger than the firm's, and the government pays the firm the difference. If interest rates rise, 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 specifically 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, 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 point in time. The value of the swap in Illustration 1 grows to negative \$4.8 million as BMA declines in the first two years. If BMA had risen, the 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 precise 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, meaning they require no initial investment on the part of a government, or a payment that is small relative to what would otherwise be required to obtain the same results.
- 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.

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 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 BMA, while the other is based on 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. Finally, *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.

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 value 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. The PV that accompanies this supplement sets forth the GASB's proposals for new standards related to 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, as well as the change in that fair value from year to year. Fair value is either the price something is expected to have if sold on the open market between two unrelated willing parties or the value of future cash flows in today's dollars.

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). Provided a derivative is not a hedging derivative, the increase or decrease in the fair value of the derivative would be reported in the change statements (such as the statement of revenues, expenditures, and changes in fund balances) as an increase or decrease in investment income, respectively. However, if a derivative is effectively hedging (reducing) the risk it was created to address, then the annual changes in the derivative's fair value generally would be deferred.

How Would a Government Identify and Report a Hedge?

For a derivative to be considered a hedge, a government's declared objective for entering into the derivative would have to be hedging a specific risk. The derivative also would have to be associated with an item that is eligible to be hedged and that is not reported in the financial statements at fair value. Items eligible to be hedged 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 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.

As noted above, the changes in fair value of a derivative that is an effective hedge would be reported in the balance sheet or similar financial statement as deferred credits (accumulated increases in fair value) or deferred charges (accumulated decreases in fair value), rather than being reported as gains or losses in investment income in a government's change statements. Each year's change in fair value would be added to the deferrals in the balance sheets. Normally, when the derivative concludes, the accumulated deferred credits or charges that remain would be reported as gains or losses in investment income, respectively, in the change statements. If the hedging derivative remains effective and continues until its planned conclusion, the deferrals will balance out the value of the derivative until that value declines again to zero when it concludes.

For the interest rate swap in Illustration 1, the fair value of \$2,972,051 would be reported on the liability side of the balance sheets as of June 30, 2002, and the decrease in fair value would be reported as a deferred charge of \$2,972,051 on the asset side. (See page 47 of the PV.) The amount by which the government's payment exceeded the firm's—\$2,133,743—would be 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, 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, 2003, the balance sheets would include the swap at a fair value of negative \$4,782,436, and the decrease in fair value of \$1,810,385 would be added to the deferred charge account (for a total of \$4,782,436).

A Hedge That Ends Early or Becomes Ineffective

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

The swap in Illustration 1 ends when planned and remains effective throughout the period of the hedge; the value of the swap declines to zero when it concludes and there is no gain or loss. However, when a derivative ends early or becomes ineffective, the accumulated deferrals from prior years would be reported as a gain or loss in investment income, plus or minus the changes in fair value for that year. Illustration 3 (beginning on page 62 of the PV) depicts a derivative that becomes ineffective during the fiscal year that ended on June 30, 2004. The financial statements for 2004 would report the accumulated deferred charges as of the end of fiscal year 2003—\$3,973,121—less the increase in the derivative's fair value in 2004—\$2,432,573—as a loss in investment income. In other words, \$1,540,548 would be deducted from the amount reported as investment income in the change statements.

Once a derivative becomes ineffective (that is, when it no longer falls within the parameters set forth in this proposal), deferral accounting would cease. Thereafter, annual changes in fair value would be reported in the change statements as gains and losses in investment income. The fair value of the derivative in Illustration 3 increases by \$1,520,548 in fiscal year 2005, and that amount is reported as investment income.

How Would a Government Determine If a Hedge Is Effective?

The GASB proposal would require governments to evaluate effectiveness when the hedge begins and then afterwards at least as often as financial statements are prepared. (For most governments, that would be once a year.) Governments would be allowed to use one of three approaches to evaluating effectiveness—consistent critical terms, synthetic instruments, or quantitative techniques.

Consistent Critical Terms

If the *critical terms* of the derivative and the terms of the item the derivative 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 and both are based on BMA—then the hedge is presumed to be effective. Under such circumstances, any change in the fair value or cash flows of the item being hedged is basically offset by changes in the fair value or cash flows of the hedging derivative. This method is limited to derivatives that are swaps. Other types of derivatives, and swaps with critical terms that are not consistent, would be evaluated using the synthetic instrument method or a quantitative technique.

Synthetic Instruments

In a derivatives transaction, the item being hedged and the hedging derivative may be combined to create a theoretical or “synthetic” instrument. The synthetic instruments method involves the calculation of an interest rate (or commodity rate, as appropriate) for the synthetic instrument based on the historical experience prior to entering into the derivative and the actual experience to date following the start of the derivative. 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 hedge is considered effective for financial reporting purposes. If the synthetic rate is outside that range, a government would examine the rates over the life of the derivative thus far. If the average synthetic rate over that period falls within the 90 to 111 percent range, then the hedge 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 hedge will remain effective going forward.

Consider a government engaged in a pay-fixed, receive-variable swap with a fixed rate of 4.25 percent. At the end of the fiscal year, the government calculates a synthetic interest rate for the swap of 4.80 percent. The synthetic rate divided by the fixed rate equals 112.94 percent, which is outside of the range that is considered effective. The government then calculates a synthetic rate for the life of the derivative thus far of 4.65 percent, which is 109.41 percent of the fixed rate. Because the government is not aware of any relevant new market conditions, it concludes that the hedge is effective for financial reporting purposes and continues to defer the changes in the fair value of the derivative. If the government had been aware of any new conditions in the market that would indicate that the hedge would not be effective in the future,

the government would have concluded that the hedge was ineffective for financial reporting purposes, regardless of whether the synthetic rates were within the acceptable range or not.

Quantitative Techniques

The PV identifies two *quantitative techniques* that may be used for evaluating effectiveness—dollar-offset and regression analysis. The *dollar-offset* method divides changes in the fair value or cash flows of the hedged item with those of the hedging derivative, or vice versa. As long as the result of this calculation falls within a range of 80 to 125 percent, the hedge is considered effective for financial reporting purposes.

Regression analysis examines the statistical relationship between changes in the fair value of the hedged item and the hedging derivative. For a derivative intended to hedge a loss of cash flows, the relationship between the changes in fair value of the hedging derivative and a “hypothetical” derivative are compared. The hypothetical derivative is a “perfect hedge”—one that has critical terms that exactly match those of the variable-rate item being hedged.

For a hedge 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 .

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

In 2003, the GASB issued a staff Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*, requiring a government to disclose the following information about any of its derivatives that were not reported in the financial statements at fair value. Because the provisions of the PV would result in derivatives being reported at fair value in the financial statements, the GASB is proposing that these note disclosures be required for derivatives in general:

- The types of derivatives, as well as the government’s reasons for entering into the derivatives
- Significant terms of the derivatives (see the example on page 49 of the PV), such as:
 - The indexes or interest rates they are based on, including any limitations on the impact that changes in the indexes or rates can have on the derivatives
 - Options embedded in the derivatives
 - Starting and ending dates
 - The amount of cash that changed hands, if any, when the derivatives were initiated
- The fair value of the derivatives as of the date of the financial statements and an explanation of any significant assumptions or methods used to estimate it (see page 49 of the PV)
- If a derivative is an interest rate swap or other transaction that is associated with debt, the government discloses the net cash flows of the derivative and the debt service requirements of the debt (see page 50 of the PV)
- The risks to which the derivatives expose the government:

- 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 in the derivatives contracts (see page 49 of the PV)
- Credit risk—a government reports the credit quality rating of the firm and the maximum potential loss if the firm fails to fulfill its obligations, and describes the collateral or other security supporting the derivatives (see page 49 of the PV)
- Interest rate risk—a government describes how the terms of its derivatives increase its exposure to interest rate risk (see page 82 of the PV)
- Basis risk—a government discloses the derivative’s payment terms and any payment terms of the government’s associated debt (see pages 59 and 60 of the PV)
- Rollover risk—a government discloses the maturity of the derivative and the maturity of the associated debt
- Market-access risk—a government indicates if it is exposed to the risk of being unable to borrow (see page 110 of the PV).

The PV also proposes that a government would disclose the following new information:

- Which of the four methods it used to evaluate the effectiveness of its hedging derivative
- The actual critical values that resulted from the government’s assessment of hedge effectiveness (such as the R-squared statistic for multiple regression or the synthetic interest rate) (see the example on page 60 of the PV)
- The amount of ineffectiveness, if any, in a derivative that is a hedge
- A government’s derivatives activity during the year.

Hedge Ineffectiveness

Even if a hedge is determined to be effective *for financial reporting purposes*, it may be ineffective to a certain degree. For example, a hedging derivative might be evaluated using the dollar-offset method and be found to have a critical value of 90 percent. The hedge would be deemed effective because it falls within the 80 to 125 percent range. However, it is less than fully effective (which would be a critical value of 100 percent). This government would therefore be required to disclose the amount of ineffectiveness of the hedge. (See pages 60 and 61 of the PV.) Governments that determine that a hedge is effective using a method that presumes effectiveness, such as consistent critical terms, would not disclose ineffectiveness.

For a derivative intended to hedge against a loss of fair value, a government would disclose the difference between the changes in fair value of the hedged item and the hedging derivative. For a derivative intended to hedge against a loss of cash flows, a government would disclose the difference between the changes in fair value of the hedging derivative and a hypothetical derivative. (See the discussion of regression analysis above for an explanation of the hypothetical derivative.)

Derivatives Activity during the Year

Governments also would be required to present a table summarizing changes in derivatives balances during the period covered by the financial statements (generally a fiscal year). (See the illustration on page 48 of the PV.) A government’s derivatives would be aggregated by type (such as receive-fixed swaps, pay-fixed swaps, rate locks, futures, and so on) and reported in

three categories—derivatives that hedge fair value, derivatives that hedge cash flows, and derivatives that are not hedges. For each type of derivative, the table would:

- Start with the fair value as of the beginning of the year
- Add the fair value of new derivatives that were entered into during the year
- Subtract the fair value of derivatives that ended during the year
- Add or subtract the change in fair value of the derivatives during the year (referred to as marking to market)
- To obtain the final fair value at the end of the year (which is reported in the balance sheets).

The table also would include the *notional amount* for each type of derivative as of the end of the year. The notional amount is the stated amount upon which swap payments are based, such as the principal amount of a bond. For instance, in Illustration 1 the notional amount initially is \$100 million, the amount of variable-rate debt issued by the government; the firm's payments to the government are determined by applying the BMA rate to the outstanding principal of the variable-rate debt.

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. Therefore, governments 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 (page 84 of the PV), you can see that the government is reporting debt service expenditures and interest expenses related to the repayment of the derivative.

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. (See the notice to recipients at the front of the PV.)

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. A PV 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. In what ways would information about derivatives be important to your work, the decisions you make, or the research you conduct? If it would not be important to you, why would it not be relevant?
2. Governments would be required to report information about the fair value of their derivatives in the financial statements. (See pages 4 and 5 of this supplement, and paragraphs 14–16 of Chapter 2 and paragraphs 1–3 of Chapter 3 in the Preliminary Views document.) How would you use this information to inform the decisions you make, your research, or the conclusions you draw about a government’s financial status? (Please be as specific as possible.)
3. Governments would be required to disclose additional information about their derivatives in the notes to the financial statements. (See pages 7–9 of this supplement and Chapter 4 in the Preliminary Views document.) How would you use this information to inform the decisions you make, your research, or the conclusions you draw about a government’s financial status? (Please be as specific as possible.)
4. 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 the issues raised in the front of the PV.

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/dpls.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. 26–4P
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Submissions are requested by July 28, 2006.

The GASB is holding public hearings, panel discussions, and a roundtable for financial statement users where you can offer your comments in person. The roundtable will provide 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 other users. The panels will feature persons from

various perspectives—such as a preparer of financial statements, an auditor, a user of financial statements, and a participant in the derivatives community.

- Public Hearing: June 21, 2006, San Diego, CA, in conjunction with the annual conference of the Association of Government Accountants. The hearing will be held at the San Diego Marriott Hotel & Marina, 333 West Harbor Drive, beginning at 9:00 a.m. PDT.
- Panel Discussions and Public Hearing: July 10, 2006, in New York City, beginning at 9:00 a.m. EDT at Milano The New School for Management and Urban Policy, 72 Fifth Avenue (between 13th and 14th Streets), 3rd Floor (Room 321).
- User Roundtable (for external users only): July 10, 2006, in New York City, beginning at 1:00 p.m. EDT at Milano The New School for Management and Urban Policy, 72 Fifth Avenue (between 13th and 14th Streets), 3rd Floor (Room 321).

If you wish to speak at a hearing, you should notify the GASB of your intent by writing and submit a copy of your comments, using the address on page 10, no later than June 9 for the San Diego hearing or June 30 for the New York City hearing.

If you wish to participate in the panel discussions or user roundtable, written comments are not required, but you need to notify the GASB of your intent. Observers are welcome at the hearings, panels, and roundtable, but advance registration is required for security reasons at the New York City location. You can register to participate or observe by submitting your name and affiliation to Ragan Vincent at 203-956-5372 or rpvincent@gasb.org no later than July 7. You will need photo identification to enter the New York City location.

Please read the descriptions and participation requirements in the notice of public hearings in the PV.

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 to its due process documents (the publications it releases to obtain feedback on proposed changes to governmental accounting and financial reporting standards).

This booklet is a plain-language supplement that accompanies a Preliminary Views (PV) document containing proposed changes to the information that state and local governments are required to report about derivatives transactions—*Accounting and Financial Reporting for Derivatives*. 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 PV’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 PV, 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

the forum of financial statement users, during its deliberations prior to formally releasing draft accounting and financial reporting standards for additional public comment.

WHAT IS THE GASB?

The GASB is the private, nonpartisan, nonprofit organization that works to create and improve the rules 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 GASB's counterpart for the private sector, the Financial Accounting Standards Board. 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 (AICPA). 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 in accordance with 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 Foundation 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.

(This page intentionally left blank.)

DERIVATIVES PLAIN-LANGUAGE SUPPLEMENT RESPONSE FORM

Please complete this form and submit it to the GASB at the address listed on page 10 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/dpls.html> or via email to director@gasb.org.

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

1. In what ways would information about derivatives be important to your work, the decisions you make, or the research you conduct? If it would not be important to you, why would it not be relevant?

2. Governments would be required to report information about the fair value of their derivatives in the financial statements. (See pages 4 and 5 of this supplement, and paragraphs 14–16 of Chapter 2 and paragraphs 1–3 of Chapter 3 in the Preliminary Views document.) How would you use this information to inform the decisions you make, your research, or the conclusions you draw about a government’s financial status? (Please be as specific as possible.)

3. Governments would be required to disclose additional information about their derivatives in the notes to the financial statements. (See pages 7–9 of this supplement and Chapter 4 in the Preliminary Views document.)
How would you use this information to inform the decisions you make, your research, or the conclusions you draw about a government’s financial status? (Please be as specific as possible.)

4. 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 26–4P

401 Merritt 7, PO Box 5116

Norwalk, CT 06856-5116