



Governmental Accounting Standards Board
of the Financial Accounting Foundation

May 2006

GASB Proposes to Put Derivatives in the Financial Statements

In recent years governments have been discovering the usefulness of an often-complex financial arrangement called a “derivative.” Some derivatives help governments to lower their borrowing costs. Some derivatives provide governments a payment up front, which can be useful when cash is tight. Others can help a government reduce the possibility that it will lose cash flows or the value of its assets in the future. Still other derivatives are essentially investments intended to generate additional income.

What they all have in common is that they require little or no initial payment from a government, they can be settled early with a cash payment or the transfer of an equivalent asset, and they are based on an entirely separate transaction, agreement, or rate. In other words, the cash flows or value of a derivative *derive from* what happens in the separate transaction, agreement, or rate.

Considering their many potentially beneficial uses, it is not surprising that an increasing number of governments are entering into their first derivative. Although precise numbers are not available, persons involved in derivatives say that their number and value have grown dramatically over the past 10 to 15 years.

Although derivatives hold the potential to be a favorable financial management tool for governments, they are not completely worry-free. While a government’s motivations for entering into a derivative may be prudent, the derivative itself may expose a government to risks that it otherwise would not face. That means a derivative intended to reduce a government’s exposure to risk could end up costing a government some of its cash flows.

The public is largely unaware of derivatives and the involvement of state and local governments in them. Until recently, governments were not required to disclose any information about their derivatives, and few derivatives are reported in their audited financial statements. For these reasons the Governmental Accounting Standards Board (GASB) has published a proposal to make derivatives more transparent to the user of governmental financial statements.

What Is the GASB Proposing?

In 2003 the GASB issued a staff technical bulletin that required governments to disclose the value of their derivatives in the notes to their financial statements and to describe the extent to which their derivatives exposed them to the risk of losing cash flows or asset value. The GASB then set to work on a more comprehensive standard for reporting derivatives. At the end of April the GASB published a Preliminary Views document, *Accounting and Financial Reporting for Derivatives*, which proposes to place derivatives in the financial statements themselves and to augment the required note disclosures.

Derivatives in the financial statements

In general, the GASB is proposing that the fair value of derivatives be reported as assets or liabilities in the financial statements (depending upon whether they represent resources or claims on resources, respectively). Fair value is either (a) the value of the derivative's future cash flows in today's dollars or (b) the price it would fetch if it could be sold on an open market. Annual changes in the fair value of the derivatives would be reported in the financial statements as increases or decreases in investment income.

As mentioned above, some derivatives are intended to reduce the risk of losing cash flows or the fair value of assets. If such a derivative, called a "hedge," is effectively reducing the risk it was created to address and is associated with something that is not reported in the financial statements at fair value (such as a outstanding bonds), then the annual changes in its fair value would be deferred. In other words, instead of being reported as investment income in the change statements (such as the statement of revenues, expenditures, and changes in fund balances), the changes in fair value would be accumulated in the statement of net assets or balance sheet as deferred credits (increases in fair value) or deferred charges (decreases in fair value). Deferral would continue until the derivative ends or ceases to be an effective hedge, at which time any remaining deferred credits or charges would be reported in investment income.

The GASB proposal details the characteristics of a hedge that qualifies for this special form of accounting. It also lays out acceptable methods for determining if a hedge is effective. The document contains extensive illustrations that exhibit how the proposal would apply to a variety of common types of derivatives and the information that would be reported about them in the financial statements and notes.

Derivatives in the notes to the financial statements

If enacted as a standard, the GASB's proposal would result in a government reporting the following information about its derivatives in the notes to the financial statements:

- The types of derivatives, as well as the government's reasons for entering into the derivatives

- Significant terms of the derivatives, such as starting and ending dates, the indexes or interest rates they are based on, and the amount of cash, if any, that changed hands 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
- A table summarizing how the fair value of the derivatives changed during the period covered by the financial statements, including the starting value, new derivatives entered into, derivatives that ended, and the final value
- The net cash flows of the derivative and the debt service requirements of the debt if a derivative is associated with debt
- Which of the methods the government used to evaluate the effectiveness of its hedging derivative, the actual critical values that resulted from the evaluation, and the amount of ineffectiveness, if any, in a derivative that is a hedge
- The risks to which the derivatives expose the government, including:
 - Termination risk—the possibility that a derivative may end earlier than expected, thus depriving the government of the protection from risk and potentially requiring it to make a significant termination payment
 - Credit risk—the chance that the firm on the other side of the derivative will not make good on its promise to pay the government
 - Interest rate risk—the risk that changes in interest rates could reduce the value of the derivative to the government
 - Basis risk—the possibility the government may lose cash flows because of differences in the indexes upon which a derivative is based
 - Rollover risk—when a derivative ends before the item it is hedging does, the chance that the government will no longer be protected against rising interest rates and may not be able to enter into a new derivative with similar terms
 - Market-access risk—the chance that the government will not be able to issue debt or that doing so will become more expensive.

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. Therefore, a government would report a liability on the statement of net assets or balance sheet equal to the cash it 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 net payments to the firm would be reported in the financial statements as a repayment that reduces the outstanding liability in the balance sheets.

How Can You Learn More about the GASB's Proposal?

The Preliminary Views document can be downloaded free of charge from the GASB's Web site, www.gasb.org. The document not only describes what the GASB is proposing, but also provides considerable background information about derivatives and explains the reasoning behind the GASB's proposals. The Project Pages section of the GASB Web site offers background information about the research, deliberations, and decisions leading to these proposals.

The GASB also has published a plain-language supplement to the document. The supplement—which was written especially for the external users of financial statements and with a minimum of technical accounting terminology—also can be downloaded free.

How Will the GASB Be Gathering Public Input?

The GASB is offering a number of ways for the public to respond to its proposals. In addition to the traditional methods of submitting comments by email or letter, for the first time the GASB has provided Internet-based comment forms for both the Preliminary Views document and the plain-language summary. The comment deadline is July 28.

There are also several opportunities to share your views in person. A public hearing will be held in San Diego on June 21 in conjunction with the annual conference of the Association of Government Accountants. In the morning of July 10 the GASB will conduct panel discussions in New York City, featuring individuals with different perspectives—such as a government finance officer, an auditor, a financial statement user, and a member of the derivatives community. If time permits, traditional public hearing testimony will be heard at that time as well. In the afternoon there will be a roundtable discussion exclusively for external financial statement users, such as bond analysts, legislative staff, and researchers at citizen and taxpayer groups.

Instructions for submitting comments, the addresses of the Internet forms, and details on the hearing, panels, and roundtable can be found in both the Preliminary Views document and the plain-language summary.