



ACCOUNTING AND FINANCIAL REPORTING FOR DERIVATIVE INSTRUMENTS— A FEW BASIC QUESTIONS AND ANSWERS

1. What is the GASB?

The Governmental Accounting Standards Board or GASB is a private, independent, not-for-profit organization. (It is not a federal agency, nor is it associated with the Federal government.) The GASB, through an open and thorough due process, establishes and improves standards of financial accounting and reporting for state and local governments.

The GASB has issued a new Statement to improve the accounting and financial reporting of derivative instruments that will result in greater consistency and transparency of those transactions.

2. What is a derivative instrument and how does it affect a state or local government?

A derivative instrument is an often complex financial arrangement in which two parties agree to make payments to each other. These obligations generally are netted, and a single net payment is made. Derivative instruments are leveraged, meaning they are entered into with little or no initial investment. Most derivative instruments are entered into by governments with the intent to lower the costs of borrowing, lock-in prices, or lower price volatility.

3. What risks do derivative instruments present?

While a valuable financial instrument, derivative instruments also present significant risks to governments that users of financial statements should be aware of:

- Termination risk—the possibility that a derivative instrument 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 instrument 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 instrument to the government
- Basis risk—the possibility the government may lose cash flows because of differences in the indexes upon which a derivative instrument and the item it hedges are based—for example, the London Interbank Offered Rate versus the AAA general obligations index
- Rollover risk—the maturity of the derivative instrument is shorter than the maturity of the associated debt, leaving the government unprotected in the future
- Market-access risk—the chance that a government will not be able to issue debt
- Foreign currency risk—the possibility that changes in exchange rates will adversely affect the value of a derivative instrument.

4. Why is an accounting standard on derivative instruments for governments necessary?

The use of derivative instruments by governments has become much more prevalent over the past several years and current accounting standards for derivative instruments are not consistent. Many derivative instruments are reported on the financial statements only when their associated cash payments are made or received. On the other hand, some derivative instruments are reported at their fair values. In all cases, current standards require governments to disclose information about their derivative instruments to financial statement users in the notes to the financial statements.

Derivative instruments can represent significant resources to governments or claims against governmental resources. For example, termination of a derivative instrument can have a significant impact on a government's financial position. Accordingly, the GASB believes that the best way to inform financial statement readers about the use of these instruments is to report them on the face of the accrual basis of accounting financial statements in a consistent manner that reflects their current prices or fair values.

5. How will derivative instruments be reported in the financial statements?

As previously noted, the new Statement requires that most derivative instruments be reported on the financial statements at their fair values. The changes in fair values of hedging derivative instruments are reported as deferred inflows and deferred outflows on the statement of net assets. A hedging derivative instrument significantly reduces an identified financial risk by substantially offsetting the changes in cash flows or fair values of its associated item. The changes in fair value of other derivative instruments that are investment derivative instruments, including those that are ineffective hedges, are reported as income or loss in the investment revenue classification in the current year.

6. How was the Statement tailored for the state and local government financial reporting environment?

A key consideration of the state and local government reporting environment is whether the current year's resources were sufficient to cover the current year's costs. When employed as hedges that are determined to be effective based on the criteria provided in the Statement, the fair value gains and losses of derivative instruments do not relate to the current year, but to future periods. In that case, those fair value changes would be deferred and reported as inflows or outflows of resources in future periods, not distorting the current year assessment of interperiod equity.

7. How was the final Statement changed from what was in the Exposure Draft that the GASB issued in June 2007?

Other GASB projects are addressing how governmental funds measure and report transactions. Accordingly, the final Statement does not address how governmental funds (which employ the current financial resources measurement focus) should report derivative instruments. Also, the Board decided that further elaboration was necessary regarding the meaning of what "on or about" means in the context of the repricing dates of a hedging interest rate under the consistent critical terms method. In addition, the Board decided that financial guarantee contracts, loan commitments, and insurance contracts are outside of the scope of the Statement.

8. How is the GASB assisting preparers, auditors, and financial statement users to understand the Statement?

An Implementation Guide on this standard is being prepared and is expected to be issued in the first quarter of 2009. And the GASB members and staff will continue to provide training at seminars and conferences to inform financial users, preparers, and auditors about these important changes.

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