



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 that—through an open and thorough due process—establishes and improves standards of financial accounting and reporting for state and local governments.

The GASB currently has proposed a new standard to improve the accounting and financial reporting of derivative instruments by state and local government by encouraging greater consistency and transparency.

2. What is a derivative instrument and how does it benefit state and local governments?

A derivative is an often complex financial arrangement in which two parties agree to make payments to each other. Each party has a different obligation. Derivative instruments are leveraged, meaning they are entered into with no or small initial investments. 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:

- Their complexity may make it difficult to comprehend the precise payment terms.
- There is potential for untimely and material termination payments that may cause a squeeze on a government's liquidity.
- By entering into a derivative instrument, a government becomes exposed to the credit risk of the counterparty—which over time could become a concern.
- As a leveraged instrument, a derivative instrument may amplify changes in markets and prices, thereby generating significant fair value gains and losses.
- Depending on the structure of the derivative instrument, state and local governments may need special expertise to monitor the transaction.

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

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, certain terminations of a derivative instrument can have a material impact on a government's financial position. Accordingly, 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 financial statements in a consistent manner that reflects their current prices or fair values.

5. What would an accounting standard on derivative instruments accomplish?

The proposed accounting standard would require derivative instruments to be reported on the financial statements at their fair values. The changes in the fair value of a hedging derivative instrument would be reported as deferred inflows and outflows. The changes in fair value of other derivative instruments would be reported immediately as income or loss. A hedging derivative instrument significantly reduces an identified financial risk by substantially offsetting the changes in cash flows or fair values of the item it is associated with.

6. How was the proposal 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, 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 and outflows of resources in future periods.

7. How was the proposal changed from what was in the Preliminary Views that the GASB issued in April 2006?

The GASB proposal simplifies the disclosure requirements considered in the Preliminary Views while retaining the information that is important to financial statement users. Governments would be allowed to aggregate derivative instruments by type, if appropriate. Derivative instruments that are investments would follow existing disclosure requirements for investments, rather than those being proposed for hedging derivative instruments. Governments also would not be required to calculate and disclose the amount of ineffectiveness in their hedges. The proposal would allow governments to use acceptable methods of assessing effectiveness other than those specifically described in the standard. Finally, the ED would require reporting of "synthetic guaranteed investment contracts" at contract value, rather than fair value like other derivative instruments.

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