Governmental Accounting Standards Board
of the Financial Accounting Foundation

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GASB Derivatives Standard to Bring Enhanced Consistency and Transparency to Governmental Financial Statements

In 2003 the GASB issued a staff technical bulletin requiring governments to disclose the value of their financial arrangements known as “derivatives” in the notes to their financial statements and to describe the extent to which these arrangements exposed them to financial risks. At the most basic level, a derivative instrument is an agreement that transfers risk from one party to another and is typically used for risk management or investment purposes. After an extensive due process that gathered input from a broad spectrum of interested parties, on June 30 the GASB issued a final derivative instruments standard, Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.*

The use of derivative instruments by state and local governments has become significantly more prevalent over the past several years. These instruments, though sometimes highly complex and requiring special expertise and ongoing monitoring, can help governments more effectively and predictably manage their exposure to a specific risk. By entering into these arrangements, governments can take advantage of the economics of an underlying transaction without actually entering into the transaction itself (for example, a utility company enters into a natural gas futures contract to lock in a fixed price without actually having to buy the gas). But at the same time, derivatives may expose a government to significant risks that it would not otherwise face. For example, when a government enters into an interest rate swap, it may be exposed to credit risk.

Derivative instruments are rooted in, or *derive* from, how market prices change in the separate transaction or agreement. A typical derivative instrument is entered into with little or no initial payment, can be settled with a cash payment or the transfer of an equivalent asset, and has a value based on a separate transaction or agreement. That is, the cash flows and fair values of derivative instruments are determined by market prices, such as bond or commodity prices. Some derivative instruments may even provide an up-front cash payment to a government.

In summary, derivative instruments offer governments a broader array of options than would otherwise be available for achieving a number of desired results, including reducing and managing various economic risks, lowering borrowing costs, and generating income. As noted earlier, derivative instruments also may expose a government to significant risks.

Reporting Derivative Instruments in the Financial Statements

Statement 53 requires governments to measure most derivative instruments at fair value as assets or liabilities in their accrual-based government-wide, proprietary fund, and fiduciary fund financial statements (but not in the governmental fund financial statements). The fair value of a derivative instrument is either the value of its future cash flows in today's dollars or the price it would bring if it could be sold on an open market.

By requiring that derivative instruments be reported on the face of the financial statements of state and local governments, Statement 53 makes these arrangements more consistent and transparent for users of governmental financial statements. Ultimately, Statement 53 gives financial statement users access to information needed to evaluate the inherent risks that derivative instruments can potentially pose to the financial health of governments, and to better understand the nature of these transactions, including how their value and cash flows change over time. Consequently, users will now have access to a more complete picture of a government's finances, allowing them to make better informed decisions about those finances.

In general, the fair value of a derivative instrument as of the end of the period covered by the financial statements will be reported in the statement of net assets (balance sheets). Changes in fair value should be reported in the flow of resources statements (such as the statement of activities) as investment gains or losses. However, the annual changes in the fair value of a *hedging derivative instrument* should be reported as deferred inflows or deferred outflows on the statements of net assets.

Hedging Derivative Instruments

A hedging derivative instrument significantly reduces financial risk by substantially offsetting changes in the cash flows (a cash flow hedge) or fair values (a fair value hedge) of an associated item that is eligible to be hedged. Statement 53 details methods for testing whether a derivative instrument meets this definition.

The Board concluded that deferring changes in the fair value of hedging derivative instruments provides a better measure of interperiod equity than recognizing them in the current period. In other words, the benefit to or burden on taxpayers resulting from the fair value changes will not occur until a point in the future (such as when the derivative instrument ends) and therefore the changes should not flow through the flow of resources statements until that time.

Deferral of changes in fair value will last until the hedging derivative instrument ends or ceases to significantly reduce risk, at which time most deferred gains or losses will be reported in the change statements.

Required Notes to the Financial Statements

Statement 53 requires a note disclosure that includes summary information about a government's derivative instruments. The government's derivative instruments are divided among those related to governmental activities, business-type activities, and fiduciary funds. Within each of those three groups, the derivative instruments are presented in the following categories (a) hedging derivative instruments (distinguishing between fair value hedges and cash flow hedges) and (b) investment derivative instruments, including hedges that were determined to not be effective.

Governments should provide additional information about their use of hedging derivative instruments. The information should include a government's objective for entering into the derivative instrument, significant terms of the derivative instrument, and the net cash flows of derivative instruments that hedge debt. The disclosure also should highlight the risks to which derivative instruments expose a government, including:

- 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.

Rather than apply the hedging derivative instrument disclosures, derivative instruments that are considered investments will be disclosed according to the requirements set forth in GASB Statement No. 40, *Deposit and Investment Risk Disclosures.*

Incorporating Feedback

While the basic reporting requirements laid out in the GASB's June 2007 Exposure Draft have been retained in the final standard, the GASB did make a number of notable changes based on public feedback it received and further study.

Most significantly, the Board decided not to address the issue of reporting derivative instruments at fair value in the governmental fund statements in this Statement. The Board will reserve consideration of this issue for its conceptual framework project on recognition and measurement attributes. 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.

When Does the Standard Take Effect?

Governments are required to implement Statement 53 for periods beginning after June 15, 2009. Early application is encouraged.

- **Order Statement 53**
- **Read the news release**
- **Read more about the Derivative Instruments project**