

A night-time photograph of the Chicago skyline, featuring several prominent skyscrapers illuminated against a dark blue sky. The city lights are reflected in the water in the foreground. The text is overlaid on the left side of the image.

GasMart 2009

Derivative Accounting  
Considerations

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# What is a derivative?

Contracts having:

- An **underlying** (the price of natural gas) AND a **notional** (10,000 mmbtu's)
- No initial net investment
- Net settlement
  - Explicit net cash settlement (financial swap)
  - Subject to a market mechanism (NYMEX contract)
  - Asset deliverable under the contract is “readily convertible to cash” (natural gas in most (all?) of the United States)
    - Physical contracts CAN qualify as derivatives

# Achieving Financial Reporting Symmetry

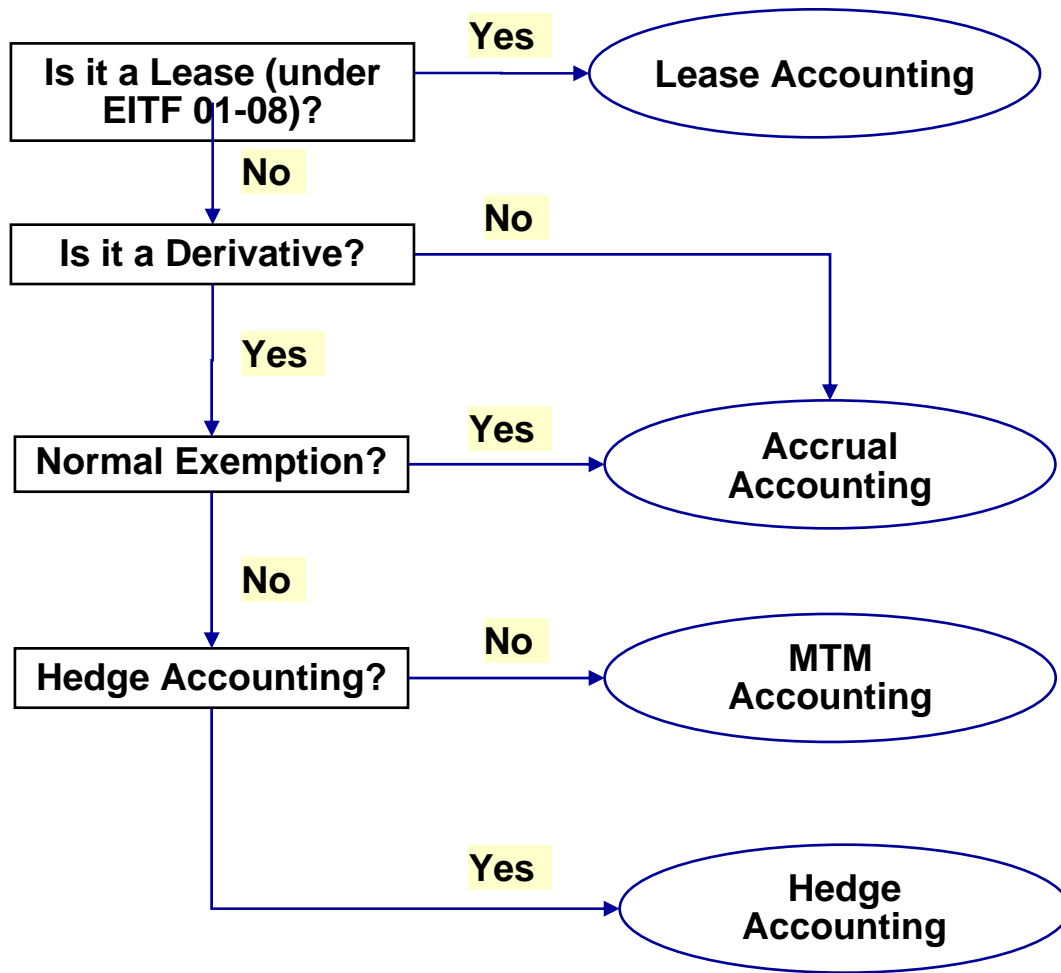
Unfortunately, economic results don't always match GAAP accounting results.

The accounting framework is complicated.

Even when hedge accounting is achieved, there can be mismatches.

Think about economics first- when all else fails, disclosure can be an effective response to asymmetrical GAAP results.

# Contract Accounting Model



Four Possible Accounting Results

# Normal Purchase/Sale (NPNS) Exception

Financial contracts CANNOT qualify.

Only physical contracts, without volumetric variability, executed in the normal course of business can qualify.

Option contracts typically CANNOT qualify. Exceptions:

- Electricity contracts meeting strict criteria.
- Optional volumes are priced at the then current market price.
- Pricing variability is ok as long as it doesn't modify volumes.

Net settlements of NPNS contracts are problematic (this includes "bookouts").

Designation/documentation is required!

# Hedge Accounting

No difference in application for physical vs. financial contracts.

Qualifying for and maintaining hedge accounting can be rigorous.

GAAP accounting mismatches can still occur due to items such as:

- Hedge ineffectiveness
- Differences in spot vs. forward pricing when using fair value hedge accounting

Designation/documentation is required!

# Forwards vs. Options

Only forward contracts (i.e., not options) qualify for the NPNS exception.

Both forwards and options can **POTENTIALLY** achieve hedge accounting.

Only net purchased options (including costless combinations of options) can qualify for hedge accounting.

Hedge accounting is more complex for options than forward contracts.

# Contact Information



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