



## National Association of State Auditors, Comptrollers and Treasurers

October 26, 2007

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Oh behalf of the National Association of State Auditors, Comptrollers and Treasurers, I am pleased to provide these comments regarding the GASB's exposure draft, *Accounting and Financial Reporting for Derivative Instruments*. The responses which we received from our members show several common themes:

1. Our members generally agree that the ED is a considerable improvement over the preliminary views, which was issued in April 2006.
2. Our members generally agree that reporting derivative instruments at fair value provides the most relevant information.
3. Some members expressed concern that the complexity of the proposed standard will decrease its likelihood of being generally accepted and will present particular problems for smaller governments to understand and implement.
4. Some members voiced concern in particular about the degree of complexity of the proposed disclosures about the terms and risks of hedging derivative instruments; these disclosures will also add considerable volume to the notes to the financial statements.

### Overall Comments

Overall, we are pleased with the breadth and scope of the disclosure and the changes from the preliminary views. There are a few items which are missing from the disclosure, though, that should be addressed. These items, along with suggestions for improving the clarity of the ED and other recommendations, are attached to this letter as a separate document.

The exposure draft provides a basic primer on the accounting and financial reporting for derivatives, something that is sorely lacking in GAAP. To our knowledge, this is the first time that journal entries, a glossary and full financial disclosure are contained in a document that is straightforward to read on a subject which is very difficult to understand. We believe that financial managers should be able to understand the standards if they understand the contracts that they have entered into.

We are pleased that GASB has released a principles-based document, rather than a rule-based document. GASB has refrained from the multitude of standards and interpretations that FASB has issued.

We are encouraged that derivatives will be reported at fair value on the face of all financial statements, regardless of measurement focus and basis of accounting – on the statement of net assets and balance sheets. We are also in favor of changes in derivatives being reported in the statement of activities and statements of revenues, expenditures and changes in fund balance as a component of investment income, unless effectively hedged. We believe that if a government is entering into these contracts for investment purposes, then like any other investment; they need to be reported at fair value as of the balance sheet date, as current period inflows and outflows of resources adjust net position.

For hedged instruments, we are also pleased that these periodic changes will be reported as deferred inflows or outflows of resources on the balance sheet and statement of net assets, if effective. It is evident that a long-term ineffective hedge becomes an investment and should be reported as an inflow or outflow.

We believe that the proposed effective date is for financial statements for periods beginning after June 15, 2009 is reasonable, allowing states to transition over the next three fiscal years. We agree with the provisions of paragraph 71 of the ED, that for derivatives in existence prior to the fiscal period, effectiveness needs to be measured only in the current period and if judged effective, then it is assumed that all prior periods are effective. However, fair values of derivatives may not be available for all prior periods presented in the statistical section. It is likely that some governments will not be able to report fair values retroactively. This circumstance, however, is not a problem (see GASB Statement No. 44, paragraph 43).

#### *Changes from the Preliminary Views*

We are pleased that the disclosure about the objectives of hedging of risk was dropped. As this standard is proposed to be implemented retroactively, finding information about decisions that were made about long-held derivatives that is auditable would have been difficult and potentially not germane to the current net position of the government.

The changed reporting model on synthetic guaranteed investment contracts (SGICs) to be reported at contract value, rather than fair value, is also consistent with business practice, as any gains or losses are embedded in the contract and are part of the investment return.

We are also pleased about the board's decisions that the disclosure about how the fair value of each derivative changed during the year should be dropped and that aggregation by type and category is preferred. These provisions would have placed an onerous burden on pension systems that have a large amount of investment derivative activity.

#### *Note Disclosures*

NASACT members who provided comments about the ED observed that the proposed note disclosures about the terms and risks of hedging derivative instruments will add volumes to the notes to the financial statements beyond what is already disclosed per Technical Bulletin 2003-1. However, judging from Illustration 12, we are pleased that the selection of effectiveness of evaluation methods in accordance with Accounting Principles Board Opinion No. 22 *Disclosure of Accounting Policies* is not illustrated. It might be preferable to move some of the proposed disclosure to the summary of significant accounting policies, including the following:

- Objectives of material derivative activity.
- Where activity and fair values are reported in the basic financial statements.
- When ineffectiveness occurs, amounts that offset investment income.
- How fair values are calculated.

Then the note disclosures would concentrate on terms and fair values. We suggest that they be grouped by type as much as possible, especially for pension fund investments. We understand though that groupings may not be possible with debt hedges due to different terms. We further suggest that the

disclosure in the Technical Bulletin be carried forth with regard to counterparty credit ratings. Those ratings should be reported in the table presented with the terms and fair values. Ranges should be used with the grouped hedges.

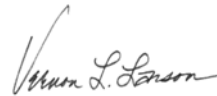
The derivative instrument payments, hedge debt, the changes in fair values and fair values tables then would be presented (page 143 of the ED). However, we believe that the objectives and terms of the hedging derivative instruments table (page 144) are somewhat redundant if the counterparty credit ratings are presented in the initial table (presented on page 139) as are the risks and contingencies presented thereafter. These could be combined with the disclosures presented on pages 141 and 142.

### *Conclusion*

As many governments have entered into these contracts upon advice of investment advisors without knowing fully about their ramifications (as stated in our testimony on the preliminary views in June 2006), we believe this is an opportunity for GASB and other organizations to educate governments in plain language about the measurement, accounting, financial reporting and internal controls that are needed for derivatives. These contracts are part of the mainstream, but represent trillions of dollars of notional value. There are tremendous benefits in them as risks are mitigated. However, there are tremendous risks and legal, administrative, audit and in some cases tax issues with derivatives as well. Training will have to occur on not only the types of derivatives that exist and their accounting and reporting, but also about acquisition and pricing, legal authority, sources of payments, how they integrate with bonds, bankruptcy, taxes, documentation, management and most importantly, risk monitoring.

As always, NASACT appreciates the opportunity to participate in the GASB's due process, both by this letter and by our testimony at the public hearing on November 1, 2007. Should you have any questions, please feel free to contact me (605-773-3378 or [vern.larson@state.sd.us](mailto:vern.larson@state.sd.us)) or Pat O'Connor of the NASACT staff (859-276-1147 or [poconnor@nasact.org](mailto:poconnor@nasact.org)).

Sincerely,



Vernon L. Larson  
President

**NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND TREASURERS**

Suggestions for Improvements to the GASB ED, *Accounting and Financial Reporting for Derivative Instruments*

October 2007

| Citation | Suggestion  |
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| General  | <p>We are concerned with the complexity of this proposed standard and the likelihood that some smaller governments will not be able to understand and implement it. With the recently effective American Institute of Certified Public Accountants Statement on Auditing Standards Number 112, <i>Communicating Internal Control Related Matters Identified in an Audit</i>, many governments could receive audit reports citing unwarranted significant deficiencies because they lack the understanding or resources to fully apply the proposed accounting and reporting standard for derivatives. The board should consider some optional reporting guidelines for smaller governments.</p>   |
| General  | <p>Overall, we believe that the layout of this exposure draft is at times hard to follow due to the extensive references to previous and subsequent paragraphs. The reader may get lost in trying to follow the cross referencing and lose sight of the actual content. For example, paragraphs 16 and 18 direct the reader to review paragraph 53 to fully understand termination events. We recommend the board organize the paragraphs in the standard to minimize the need for the user to flip back and forth through the standard in order to understand its requirements. The board should place paragraphs that compliment each other in close proximity.</p>   |
| General  | <p>Many governments use cost of funds swaps heavily, though these are not as common in industry as other swaps. Cost of fund swaps are not as efficient as index-based swaps, interest rate mode changes are monitored by the counterparty and conversion to an index-based swap may occur upon a credit downgrade or a challenge to tax exemption. However, they offer the highest fixed rate coupons; they have low liquidity and offer a true synthetic fixed rate (in other words, a perfect hedge). Cost of funds swaps have floating receipts that match interest payments due on bonds exactly. Therefore, more bond holders prefer cost of funds swaps.</p> <p>We believe that if a government uses a cost of funds swap with qualitative consistent critical terms, then hedge accounting should be presumed.</p>  |
| General  | <p>Many governments use guaranteed investment contracts or GICs to invest project fund proceeds from bonds and for debt service reserve funds. The difference between a SGIC and a GIC is not clearly defined in the document, nor is the accounting and reporting defined.</p> <p>SGIC's are contracts that establish obligations that are not owned by the government or potentially the counterparty. The counterparty agrees to pay book value, regardless of the actual market value of the underlying collateral or assets upon specific circumstances or specific dates.</p> <p>With GICs however, the government deposits funds with the counterparty and purchases investments. There is credit risk, but GIC counterparties usually have the highest credit ratings, or else the government will not or cannot invest in them. Typically, the underlying collateral is either over-collateralized or has the highest ratings, being either US</p> |

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|                         | <p>government securities or similar instruments. Withdrawal from the GIC can occur at either specific dates or at any date, depending on the contract. Withdrawals are at book value as well.</p> <p>We believe that GICs are generally benefit responsive, in that usually governments cannot buy or sell the GIC without consent, there is a trustee that manages the investments and any interest crediting adjustments, losses are remote in that the underlying collateral is of the highest quality and settlement is at book value. Termination provisions are addressed in the contract.</p> <p>GICs should be disclosed similarly to SGICs, but they would not be exposed to many of the risks as defined in paragraph 64 due to the guarantee. As the contracts are not exposed to interest rate risk, basis, market access or foreign currency risk, disclosure should be limited to:</p> <ul style="list-style-type: none"> <li>• <i>Credit Risk</i> – the government’s policy of requiring collateral or other securities and the ability to access that collateral, the book value of the contract as of the balance sheet date and concentrations (for example if the government has greater than 5% of its investments with the same counterparty.)</li> <li>• <i>Termination Risk</i> – the provisions of the contract describing terminations</li> <li>• <i>Rollover Risk</i>- the provisions that are in the agreement should the government have to reinvest in a new GIC, should a termination occur. There may be “make up” provisions in the original GIC.</li> </ul> |
| ED,<br>Para. 18         | Paragraph 18 states “When identified separately as an element of investment income, the removal of the balance in the deferral account should be captioned increase (decrease) upon hedge termination.” The ED gives the option for this separate reporting on the change statement. We recommend this treatment be mandatory for consistency.   |
| ED,<br>Para. 19         | We suggest the board move the paragraph under 19a.(2), that begins with “The decision as to whether a termination re-exposes a government to a hedged risk...” to above section 19a.(1) to improve clarity. We believe this information will assist the reader in understanding sections (1) and (2). In addition, we recommend the board include additional information or examples in this paragraph to assist governments in evaluating their potential “re-exposure” to the hedged risk.   |
| ED,<br>Para. 30         | Paragraph 30 defines benchmark interest rates and names a few benchmark interest rates. Are these the only benchmark interest rates that can be used to evaluate hedge effectiveness? If not, we recommend an all inclusive list and some mechanism for updates as the markets evolve.   |
| ED,<br>Para. 31 -<br>33 | In reviewing the consistent critical terms method in paragraphs 31 through 33, we feel that the criteria for determining whether a swap is effective are too strict in that they assume perfection. For example, paragraphs 32 and 33 of the proposed standard require that interest rate swaps meet <b>all</b> of the stated criteria. Further, paragraph 32(b.) requires that the fair value of the interest rate swap be <b>zero</b> . We feel that the strict criteria provided may prevent governments from using this method. Therefore, we recommend the board add some flexibility to the criteria for applying this method to ensure it is a practical option for governments to use in evaluating hedge effectiveness.   |
| ED,<br>Para. 32         | We believe that some additional guidance may be helpful in paragraph 32 where the consistent critical terms effectiveness method is described. “The notional amount of the interest rate swap should be the same as the principal amount of the hedgeable item.” Does that mean that over the life of a debt – with multiple maturities and with allowable prepayments of principal – that the notional amount of the hedge should equal the underlying hedgeable amount? Consider a \$100M fixed rate bond series with a \$100M pay-fixed, receive-variable swap. The swap may be   |

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|                    | <p>associated and match the initial maturity schedule of the bond. However, due to prepayments (like for mortgage loan-based programs), the notional amount of the hedge may eventually only approximate and not equal the remaining principal maturity values of the bonds.</p> <p>The following sentence would appear to allow for approximate maturity matching of the interest rate swap to qualify as effective: "If the critical terms of the hedgeable item and the potential hedging derivative instrument are the same, or similar in certain circumstances, the changes in cash values or fair value of the potential hedging derivative instrument will substantially offset the changes in cash flows or fair values of the hedgeable item." However, GASB has the opportunity now to address the issue posed by slight mismatching of maturities. Perhaps a reasonableness standard of 90 percent matching of the respective maturities could be applied.</p> <p>We believe that the requirement in paragraph 32 that an interest rate swap that hedges interest rate risk have a variable payment based on a benchmark index rate without adjustment is unrealistic and restrictive. The benchmark interest rate may not be multiplied by a coefficient, such as 68 percent times LIBOR, or an addition or subtraction of a constant, such as 10 basis points. This requirement was not in the preliminary views document (paragraph 13). The use of an index with a coefficient (like 68 percent of LIBOR) is one common technique to convert the taxable LIBOR rate to a tax-free rate. This new requirement would make the use of the consistent critical term effective-ness criteria too restrictive for governments that use a coefficient with a market index like LIBOR.</p> |
| ED, Para. 54 - 58  | <p>We suggest the board move forward paragraphs 54 through 58, which discuss hybrid instruments and synthetic guaranteed investment contracts. Since these paragraphs are more descriptive in nature, the board should place them to the detailed paragraphs describing the evaluation of hedging derivatives instruments, which begin with paragraph 21. Further, we believe the board should include a reference to the guidance for synthetic guaranteed investment contracts in paragraph 7, similar to the reference made to the hybrid instrument guidance.</p>  |
| ED, Para. 60       | <p>The wording could be improved in paragraph 60. This paragraph reads as if governments are required to disclose activity for all derivatives during the year and balances for those derivatives held at year end. Based on paragraph 126 and the example at the bottom of page 143, it appears that governments are only required to report the activity and balances for those derivatives held at year end. Paragraph 60 could be reworded to make this clearer.</p>   |
| ED, Para. 60       | <p>Summary of instrument activity (Paragraph 60) – This paragraph requires a summary of activity during the reporting period <i>and</i> balances outstanding at year-end. However, the illustration given <i>only</i> presents "instruments outstanding" at year-end. Clarification should be given to prevent inconsistencies.</p> <p>In addition, the benefits would not exceed the cost of offering the suggested detail of activity <i>during the period</i>. Alternatively, a brief discussion of the types of transactions and their purpose in context of the investment policy would be more meaningful. <i>If</i> disclosure is ultimately required for financial arrangements entered into and closed during the period, further guidance and additional illustrations should be included.</p>   |
| ED, Para. 64 a (6) | <p>For the concentration of credit risk disclosure, we recommend that the board provide additional guidance on the threshold percentage. GASB has provided such guidance for this type of disclosure in GASB Statement 40.</p>   |
| ED, Paras. 64      | <p>Detail information elements for risk (Paragraphs 64 and 67(a)) – Presenting risk information on short-term investment derivatives, such as futures that are settled daily,</p>  |

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| and 67(a)                                    | would not be relevant for decision-making. We recommend limiting the counterparty disclosures to outstanding items that are more long-term in nature such as swaps and options. Secondly, estimation of maximum loss for credit risk would be burdensome and not add comparable value to financial information. Disclosure of losses incurred from actual counterparty default would be more meaningful to users. In addition, clarity is needed for paragraph 64(a)(6) that includes disclosure of “significant” concentrations of exposure to credit risk. Methodology should be included to assist in determining exposure that is “significant”.   |
| ED, Para. 126                                | According to paragraph 126, the board agreed with the respondents of the preliminary views that the summary of derivative instruments in the Statement focuses on end-of-period fair values of derivative instruments, instead of activities during the year. However, paragraph 60 still requires a summary of the derivative instrument activity during the reporting period. We would like to have a clarification on the requirement disclosure of activities during the year.   |
| Illustrations, general                       | We found the illustrations very beneficial in understanding the concepts in the standard. However, in each of the illustrations, the fair value of the hedge is presented as a given piece of information. It is my understanding that the fair value of a hedge is a present value function of the difference between the rates or prices involved applied to the contract or notional amount through the duration of the hedge agreement. Because preparers may not be aware of how to develop this information, we believe the illustrations could be improved by including a demonstration of how the fair value was determined in one or more instances.  |
| Illustration #2                              | In illustration #2, the first sentence in the section titled Journal Entries Prior to Issuance of Bonds begins with “The following journal entries related to the swap are recorded...”. However, the illustration is related to an interest rate lock not a swap.   |
| Illustrations #7 and #8                      | It was difficult for us to understand why the commodity swap and the commodity futures contract in Illustrations #7 and #8 respectively do not qualify for exclusion of normal purchase contracts in paragraph 13 of the exposure draft if commodity swaps and/or commodity future contracts are the government’s normal method of managing commodity price volatility risk. It seems that all the requirements of paragraph 13 could be met by the contracts in Illustration #7 and #8. Is the essential difference here the nature of the counterparty? In the instance of a normal purchase contract the counterparty would normally be a commodity supplier whereas in a commodity swap or futures contract the counterparty is more likely to be a market maker than a supplier of the commodity. If this is a core concept, perhaps paragraph 13 could be clarified to address this concept. |
| Plain-language Supplement, Page 9            | We believe the Plain-language Supplement, page 9, has the wrong years indicated in the discussion of the reporting of hedges that cease to be effective. The \$4,000,154 is the accumulated deferred charges through FY 20X2 and the \$2,463,868 is the change in fair value for FY 20X3 (instead of 20X3 and 20X4, respectively). This seems to be the case when looking at the example beginning on page 76 of the exposure draft (referred to in the plain-language discussion).  |
| Guidance re net or gross settlement flows in | The proprietary fund type cash flow statement treatment of net settlement payments related to hedges is not addressed in the exposure draft to our knowledge. Technical Bulletin 2003-1 (paragraph 22), which the exposure draft supersedes, states that, “... the government’s accounting policies that affect the manner of reporting derivative balances  |

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| cash flows statements of proprietary funds | and cash flows on the financial statements are not discussed because they are a well-established requirement in the authoritative accounting literature.” Presumably this refers at least in part to the GASB Statement No. 9 requirement to report cash flows gross rather than net. However, given that net settlement is a required characteristic of derivative, we are unclear whether the cash flow statements should show the net settlement flows or the gross flows related to a derivative instrument such as an interest rate swap. Neither GASB Statement No. 9 nor the related implementation guide addresses this issue to our knowledge. We believe it would be a small matter for the final derivative statement to clarify the cash flow statement treatment of derivative net settlements. |