

October 12, 2007

Director of Research and Technical Activities  
Project Number 26-4  
Governmental Accounting Standards Board  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856-5116

Dear Sir:

On behalf of the Florida Government Finance Officers Association (FGFOA), we are pleased to provide these comments regarding the *Accounting and Financial Reporting for Derivative Instruments* exposure draft. These comments were prepared based on a review of the exposure draft by the FGFOA Technical Resources Committee and by the Board of Directors.

A number of derivative related terms are defined in the proposed standard and a comprehensive glossary has been included as well.

We believe the inclusion of this explanatory data will provide significant guidance to preparers and users in implementing and understanding, respectively, the proposed standard. However, we believe replacing the term *underlyings* with the term *reference rates* may cause confusion among preparers and users of the financial statements.

The Board's belief that *reference rates* is clearer in the government environment does not support replacing a widely understood concept and definition such as *underlyings*. The financial community created not only the concept of derivative financial transactions, but the related terminology and nomenclature. Therefore, we do not believe it is necessary to create a new term in accounting for derivatives in the governmental environment when an existing term has general acceptance in the user and preparer communities.

This proposed standard will require state and local governments to report certain derivative transactions at fair value in the government-wide and fund level financial statements.

We fully agree with the proposed guidance that derivative instruments should be measured at fair value for all funds in both the government-wide and fund level financial statements. However, we do not believe normal commodity purchase/sale contracts should be excluded from the guidance provided in this exposure draft (i.e., accounted for using historical cost).

Paragraph 81 of the Basis for Conclusions states these type contracts are excluded because they are considered normal and routine transactions used to protect against future price changes. It also states the Board believes these transactions are similar to purchasing inventory in the future under a binding purchase order.

In reality, these type contracts may be entered into as a cash flow hedge separate from the routine purchase of inventory. While some governments may routinely enter into cash flow hedge agreements, other governments do not; therefore, it is not a normal or routine transaction for these governments. Even governments that routinely enter into cash flow hedge agreements may not do this for all inventory purchases. We believe this will affect financial statement comparability among governments or even within governments (i.e., a state transportation department might account for the same conceptual transaction differently than the health and human services department).

Additional support for our position is based on the reality that these types of transactions clearly have a fair value whether they are a forward or an option contract. The intrinsic and time values associated with these inventory type cash flow hedges are derived from the underlying commodities market. Therefore, these agreements would appear to be more appropriately considered a derivative hedge transaction for external financial statement reporting purposes. We also believe that in certain volatile markets, excluding these types of contracts from derivative accounting might result in misleading financial statements.

Certain provisions of the exposure draft require that changes in fair value be included in the appropriate change statement (as defined in footnote 7 on page 6 of the exposure draft) as investment income unless the derivative is a hedge (as defined in the exposure draft). However, changes in fair value for hedge derivative instruments would be reported in the statement of net assets (as defined in footnote 6 on page 5 of the exposure draft) as either a deferred inflow or deferred outflow based on its effectiveness.

We agree that how changes in fair value are reported should be based on the type of derivative transaction. The Board's position that derivative instruments that do not significantly reduce the related risk are investments (paragraph 86 in the Basis for Conclusions) is untenable. We believe reporting changes in fair value for these type contracts as deferred inflows and outflows is confusing and provides no meaningful information to the user. Additionally, we believe not reporting such changes in the change statement(s) would be misleading.

In reality, governments enter into a fair value derivative transaction with the intent to reduce an identified financial risk. Unfortunately, market conditions change and what was intended to be an effective hedge, may become an ineffective hedge. The results of these decisions should be reflected in the government-wide change statement as they represent economic decisions and transactions. At the fund level, these types of changes should be recorded in the change statement if appropriate (i.e., meets the requirements for revenue or expense/expenditure recognition under the appropriate basis of accounting). If not appropriate, conceptually, the amount should be reported as a reservation of fund equity (similar to reporting long-term interfund advances, inventories, and encumbrances at the fund level).

Paragraph 19 (2) requires amortization of any deferred balances remaining when a government remains exposed to a hedged risk. The deferral account is to be amortized over the life of the debt as an adjustment to interest expense.

We believe the Board should provide guidance as to what method of amortization should be used in these cases (i.e., straight-line, effective interest method, etc.).

Hedgeable items are to be evaluated for effectiveness if they are an existing financial instrument or an expected transaction that will result in a financial instrument (paragraph 29). Paragraph 24 states the expected transaction should be probable and supported by observable facts that are delineated in the paragraph.

We believe the examples of supportable observable facts outlined in paragraph 24 will lead to differences in reporting among government entities and may lead to financial statement manipulation by a government entity. Therefore, we respectfully ask the Board consider more definitive guidance in this area either in the final pronouncement or in a subsequent implementation guide.

A number of methods to evaluate hedge effectiveness are allowed under the proposed standard. While we applaud the Board for providing preparers options with respect to evaluating effectiveness, we are concerned that this will affect comparability within and among government financial statements. Theoretically, a government could choose to evaluate derivative instruments using different methods (within a reporting period and from year-to-year) in an effort to manipulate financial statement results.

The synthetic instrument method for synthetic fixed-rate instruments proposes the actual rate be within a range of 90 to 111 percent of the fixed rate to be effective. Based on information in paragraph 106 of the Basis for Conclusions, during due process related to the Preliminary Views document, views suggested a range of 80 to 125 percent. The Board considers the 90 to 111 percent range appropriate based on a nonrandom sample of governments.

Based on the information in paragraph 106, we believe the basis for the 90 to 111 percent is arbitrary because a nonrandom sample was used. We believe the range should be changed to 80 to 125 percent because it is no less supportable than the 90 to 111 percent range. Additionally, the 80 to 125 percent range is used in other methods (i.e., dollar offset and regression analysis) as an acceptable range for evaluating hedge effectiveness. The 80 to 125 percent range is consistent with the requirements of FASB Statement No. 133 as well. We believe consistency in the ranges and with FASB Statement No. 133 will reduce confusion among financial statement users.

Based on paragraph 85 of the Basis for Conclusions, it appears the Board does not believe governments will incur significant incremental costs to report derivatives at fair value.

While this may be true with respect to fair value amounts reported in financial statement footnotes, we do not believe this to be true for the fair value amounts required to be reported in the body of the basic financial statements. Our basis for this is the potential need to have qualified finance professionals either on staff or

on contract to calculate the various amounts required under the exposure draft. Additionally, the proposed standard has the potential to increase audit fees.

Currently, auditors are required by Statement on Auditing Standards (SAS) No. 101 to perform extensive procedures when auditing fair value measurements and disclosures. The additional procedures that would be required under SAS No. 101 would in all likelihood increase the audit fee and may even necessitate changing auditors if they did not consider themselves competent with respect to auditing fair values.

In addition to the specific additional procedures required under SAS No. 101, the new audit risk standards will generally require the auditor to assess audit risk differently based on the three categories of assertions. Theoretically, amounts recorded at fair value represent greater audit risk than those recorded at historical cost. Again, the proposed standard could result in higher audit fees in light of the new audit risk standards.

Another concern we have with respect to the potential for additional audit costs is the impact on the external auditor's independence. For many small and medium size governments, the auditor often times proposes a number of adjustments to bring the clients financial statements into conformity with generally accepted accounting principles (GAAP). Other times, the auditor might simply propose highly technical GAAP adjustments such as those contemplated in this proposed standard. In either case, the auditor might conclude the extensive work required under this exposure draft would impair their independence.

The FGFOA appreciates the opportunity to provide you our comments on the *Accounting and Financial Reporting for Derivative Instruments* exposure draft. Should you have any questions, please contact me at (407) 836-5690 or e-mail me at [mark.fostier@occompt.com](mailto:mark.fostier@occompt.com).

Sincerely,

Mark A. Fostier  
President  
Florida Government Finance Officers Association

c: FGFOA Board Members  
Ron Harring, Chair, Technical Resources Committee  
Jeannie Garner, Executive Director, FGFOA