

National Federation of Municipal Analysts

December 12, 2007

Mr. David R. Bean
Director of Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

By email to drbean@gasb.org

Dear David:

The National Federation of Municipal Analysts (NFMA) welcomes this opportunity to comment on the *Exposure Draft – Proposed Statement of the Governmental Accounting Standards Board: Accounting and Financial Reporting for Derivative Instruments*.

The NFMA is an organization comprised primarily of research analysts who evaluate credit and other associated risks of securities in the municipal bond market. Established in 1983, the NFMA has one thousand members who represent, among others, broker dealers, mutual funds, rating agencies and insurance companies.

As users of financial and operational information provided by municipal issuers, the NFMA typically supports measures that improve the quality and timeliness of that information. GASB's proposal to improve the accounting and financial reporting of derivative instruments by state and local government is, in general, consistent with NFMA's goal of better disclosure.

With that overall goal in mind, we would like to share the following comments:

Balance Sheet Reporting

- Regardless of whether hedges or derivatives are deemed to be “effective” or “ineffective”, we do not agree with the Exposure Draft's (ED's) recommendation to report in the financial statements any changes in the fair value of these instruments.

Because these fair value calculations represent deferred losses or gains, i.e. amounts that may never be realized, the proposal to report these changes seems to violate the concept that underlies the modified accrual basis of accounting, i.e. that “expenditures are recognized in the period in which they are expected to (be) require(d) to use current financial resources, revenue is not recognized until it is available to pay current obligations, and certain long-term liabilities are not recognized until due and payable.”¹

Given the municipal market's long-standing analytical focus on and understanding of an issuer's general and other governmental funds, it is our opinion that inclusion of these fair value

¹ Source: GASB website.

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calculations would detract from the analytical usefulness of these funds and probably serve to confuse users of the financial statements.

- As an alternative to balance sheet reporting, we concur with GASB's proposal that additional information about derivatives be disclosed in the notes to the financial statements. Given our concurrence, we realize that a contract-by-contract delineation of derivative exposure in the notes might provide so much information that it would be difficult to analyze, and in addition that its preparation could be cumbersome for both issuers and preparers of financial statements. We would thus support reporting in the notes to the financial statements of summary data, with the caveat that an over-aggregation of data would also not be useful to the analyst.

This position represents a partial divergence from that which we expressed in our letter of December 4, 2006 to GASB regarding GASB's *Preliminary Views: Accounting and Financial Reporting for Derivatives*, dated July 28, 2006. In our December 2006 letter, NFMA requested individual listing of each derivative exposure. We are modifying our position in light of the potential administrative burden noted above.

We also suggested in our December 2006 letter that any potential termination payments be divulged, and we continue to recommend that this and other pertinent information be disclosed in the notes to financial statements.

Effectiveness Criteria

- If GASB does decide to implement the ED's recommendation as described above in *Balance Sheet Reporting*, we would like to opine on the "effectiveness" criteria mentioned in the ED. First, we agree with GASB's recommended usage of the consistent critical terms method where appropriate. We also agree that the synthetic instrument and dollar-offset methods should be used as required. However, regarding the regression analysis method, we are concerned that its criteria for judging "effectiveness" are overly forgiving.
- We are also of the opinion, as previously stated in our December 2006 letter, that the choice of method – and its underlying assumptions - used for evaluating "effectiveness" should be disclosed in the notes to the financials. It is not apparent to us that such disclosure is to occur.

Other Topics

- During the user roundtable that was held on November 1, the question arose of whether hedge/derivative obligations of discretely presented component units should be included in the primary government's financial statements.

NFMA's opinion is that presentation of this information in the primary government's financials is unnecessary, even though the primary government may typically appoint a component unit's board or there may be a financial benefit/burden situation that exists between the entities.

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Given the numerous component units that a primary government may have, and the fact that financial statements of these units are typically readily available, we feel that inclusion of such a standard would pose an undue burden to both the primary government and preparers of its financial statements.

- Another topic raised during the November 1 roundtable was whether derivative counterparties and their credit ratings should be disclosed in the notes to financial statements.

We understand that recommending this type of disclosure – i.e. naming vendors to a state or local government – would represent a departure for GASB. However, for derivative and hedge reporting we urge GASB to reconsider this stance for two reasons:

1. Derivative instruments and their counterparties play a much more significant role in a government's financial outlook than do most other types of vendors.
2. Recent turmoil in the financial markets indicates the need for municipal investors and related parties to be aware of the counterparties with which a municipality is dealing.

This recommendation is also in keeping with our letter of December 4, 2006.

NFMA would like to thank you for the opportunity to comment on the Exposure Draft, and appreciates the efforts GASB is taking to improve disclosure by municipal and related entities. We welcome the opportunity to discuss these comments at greater length.

Sincerely,

Tom Weyl
NFMA Chairman

