



Government Finance Officers Association

**TESTIMONY REGARDING THE EXPOSURE DRAFT OF THE  
GOVERNMENTAL ACCOUNTING STANDARDS BOARD ON  
ACCOUNTING AND FINANCIAL REPORTING FOR DERIVATIVE  
INSTRUMENTS**

New York City  
November 1, 2007

We are here today on behalf of the Government Finance Officers Association (GFOA) to offer testimony concerning the Governmental Accounting Standards Board's (GASB) recent exposure draft (ED) on *Accounting and Financial Reporting for Derivative Instruments*. This testimony was prepared and approved by three of GFOA's standing committees, all of whose members are active government finance officers:

- Committee on Accounting, Auditing, and Financial Reporting
- Committee on Governmental Debt Management
- Committee on Retirement and Benefits Administration.

We share GASB's view that financial statement readers need information about the use of derivatives by state and local governments. For that reason, as you will recall, GFOA supported many of the proposed disclosures in the preliminary views (PV) on *Accounting and Financial Reporting for Derivative*. We made several suggestions for changes to the PV's proposals for disclosure and we appreciate the revisions the GASB made to arrive at the disclosures that the ED proposes. We, however, believe that there is still room for further improvement in the proposed disclosures and our suggestions will be discussed below.

**Measurement and recognition**

We must again strongly object to the use of fair-value for reporting derivatives in governmental fund types. We continue to believe that fair-value reporting in this case is fundamentally at odds with the current financial resources measurement focus and the modified accrual basis of accounting used by governmental funds. We believe that the board has neglected several very important points when offering the guidance from GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, as justification for fair value reporting in

governmental funds. First, GASB Statement No. 31 was issued at a time when the only option for display was to report the fair value and related changes in the financial statements of the governmental funds. With the advent of the GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, financial reporting model another option is available. Consequently, we urge the board to limit the use of fair-value reporting to the government-wide financial statements when derivatives are used by governmental funds.

Next, the reporting of fair values in governmental funds was not applicable to all investments. Instead, the fair value requirements were made applicable to five specific types of investments. The requirement to then report fair value changes in the governmental funds operating statement was, at least in part, based on the presumption that governmental funds need liquidity to meet operating needs and, therefore, would hold short-term or marketable investments (GASB No. 31, para. 57). We do not believe that derivative transactions inherently have the same liquidity. Instead, derivative transactions are contractual arrangements which are used to achieve a desired result normally based on actual transactions under the arrangement each period. The changes in fair value are simply unrealized changes that do not affect current financial resources.

Finally, the board indicates in para. 84 of the basis for conclusions of the ED the desire to remain consistent with the fair value approach of GASB Statement No. 31 for investments. However, the board also indicates in that same discussion that it plans to address the general issue of recognition and measurement in governmental funds in a future conceptual framework project. Accordingly, we believe that rather than extend the fair value requirements of a statement that was issued at a time when accrual-basis government-wide financial statements did not exist and the statement's applicability was limited to certain investment types the board should first complete this conceptual framework project before it includes additional items in governmental funds that are inconsistent with their current financial resources measurement focus.

### **Note Disclosure**

We do not object to the proposed new activity disclosure in the case of hedging derivatives. However, in general, we are not persuaded about the usefulness of this disclosure for investment type derivatives. In this case, we believe the pertinent information is already provided on the face of the financial statements. Further, isolation of the investment derivative instrument from the related item can lead to misunderstandings about the transactions. For example, a disclosure of an increase in the fair value may appear to be positive, however, that result may be contrary to the design of the investment derivative instrument. Accordingly, these disclosures do not provide information that adds to the understanding of the amounts that financial statements already display.

We believe that such activity disclosures are particularly inappropriate for post-employment benefit plans and external government investment pools. For these entities the important point of analysis is how the entity performed in relation to its overall investment strategies and its desired rate of return. That information is already available through the display of the

information in the financial statements and the related analysis that would be provided through management's discussion and analysis. Furthermore, these entities are likely to have a much higher volume of such derivative transactions (agreements can even number in the thousands), especially as they attempt to hedge interest-rate risk and foreign-currency risk. Such entities also may have several different money managers for their investment portfolios, who enjoy considerable flexibility within the terms of their contracts. We are not persuaded that the cost of summarizing the activity for disclosure purposes, given the volume of transactions and potential multiple sources, can be justified, especially given the limited potential value of such information in these circumstances.

### **Scope clarification**

While some changes that were made to the PV in the preparation of the ED may make it clearer that the proposed guidance would only apply if a government or its agent (e.g., a contracted money manager) is directly involved in a derivative transaction, we suggest it would be helpful to expressly state this fact. Specifically, we recommend that the final guidance clearly indicate that if a government is indirectly associated with a derivative transaction (e.g., participation in an external investment pool or a mutual fund) it would not need to comply with any of the requirements of the pronouncement. If the board does not include this express statement in the final standard we recommend that this scope clarification at least be provided in the implementation guidance that is likely to be published.

The GFOA appreciates the opportunity to respond to the GASB's PV on derivatives.