

January 15, 2008

Mr. David R. Bean
Director of Research and Technical Activities, Project No. 26-4
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

The American Institute of Certified Public Accountants (AICPA) has reviewed the Governmental Accounting Standards Board (GASB) Exposure Draft (ED), *Accounting and Financial Reporting for Derivative Instruments*, and is pleased to offer its comments. We support the GASB's efforts to develop a standard for the reporting of derivative instruments as the use of derivatives by governments has been on the rise over the last decade. We believe that the issuance of a comprehensive standard on derivatives will improve the transparency of the risk these transactions pose and provide users of governmental financial statements with better information.

The ED states that its objective is to enhance the usefulness and comparability of derivative instrument information reported by state and local governments. Overall, we believe the ED meets this objective. Further, the GASB has simplified and clarified certain of the more challenging provisions of Financial Accounting Standards Board (FASB) Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB 133), based on experiences that private sector entities have had with that standard. We generally support the simplifications and clarifications that were made although as noted below we recommend that more detail be added to make the final standard more comprehensive.

The ED is an improvement over the Preliminary Views (PV) which preceded it. We were particularly pleased that the Board streamlined the hedge accounting provisions by deleting the requirement for the government's declared objective and revised the proposal to require evaluation using the consistent critical terms method and, if failing that method, only requiring one of the quantitative methods.

However, even with the improvements made since the PV, we continue to believe that the ED is not comprehensive enough. FASB 133 still provides considerably more detail than the ED. It is our view that the Board's goal should be to develop a final derivatives standard and related implementation guidance that together stand on their own. Otherwise, both preparers and auditors will likely attempt to utilize FASB 133 when questions arise as to the application of items that are not specifically addressed by the GASB or for items that are addressed by the GASB but in less detail. We believe that such analogizing to FASB 133 would be inappropriate in that the GASB is departing from the requirements of FASB 133 in many ways. We again recommend that the GASB take steps to make the final standard comprehensive to ensure that preparers of financial statements are not inclined to utilize FASB 133 to fill in the gaps. Several examples of this lack of comprehensiveness that we noted during our review include: (1) the ED is silent as to whether certain items that are specifically excluded from the scope of FASB 133 in paragraphs 10 and 14 of that standard (for example, insurance products, guarantees and royalty

agreements) would also be excluded from the scope of the GASB's proposal; (2) the dollar-offset method uses a range of 80 to 125 percent without identifying the basis for this range for readers that may not be familiar with prevalent practice under FASB 133; (3) there is no discussion of foreign currency as a hedging consideration; (4) little guidance is provided on embedded derivatives; and (5) the glossary of terms is not all-inclusive. Further, the FASB has a standing Derivatives Implementation Group (DIG), now known as the Derivatives Resource Group, that has addressed over 100 different implementation issues relating to FASB 133. In moving forward with its standard on derivatives, the GASB should begin concurrent work on an Implementation Guide that would consider the guidance previously issued through the DIG process and other government-specific derivatives issues. Such implementation guidance will be critical to assist governments as they consider derivatives issues. If the GASB does not intend to issue such guidance, the final standard should discuss the DIGs, where they would stand in the GAAP hierarchy for a state or local government, and whether it would be appropriate to use their guidance in any or all cases.

While we support the GASB's efforts in developing a derivatives standard, the Board should recognize that the issuance of such a standard will likely come with a cost to governmental entities, particularly those that are small and unsophisticated. Many governments that engage in derivative transactions will not have the expertise in-house to understand or implement the GASB standard and may look to their auditor for assistance. However, because of the auditor independence rules relating to nonaudit services, the independent auditor's ability to provide assistance to their clients in this area will likely be very limited. As a result, we believe that many of the governments that engage in derivatives will need to hire outside expertise to assist them or develop the expertise in-house.

Finally, we repeat a concern that we raised in our comments on the PV that we continue to believe should be addressed by the Board. Because the Board is taking a different approach than FASB 133 in many areas, the GASB standard will be challenging for derivatives specialists that assist governmental entities in implementing the final standard. This is because those specialists are likely to have developed their significant expertise based on the requirements of FASB 133. We believe it is not likely that those organizations with derivatives specialists will develop additional "governmental" derivatives experts, but rather that the FASB derivatives experts will be asked to assist with GASB derivatives issues and projects. For this reason, we recommend that the Board develop a crosswalk of differences between FASB 133 and the final derivatives standard that the GASB ultimately develops. This would alleviate the need for specialists around the country to prepare their own detailed analysis of the differences between the standards. It would also ensure that key differences are highlighted for both preparers and auditors and are interpreted by them in a consistent manner. The crosswalk could either be included in the final standard as an appendix or on the GASB's Web site.

The Appendix of this letter includes our detailed comments and recommendations on the ED.

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The AICPA appreciates the opportunity to comment on the ED. This comment letter was prepared by members of the AICPA's State and Local Government Expert Panel and certain

Mr. David R. Bean

January 15, 2008

Page 3

other AICPA members with derivatives experience and was reviewed by representatives of the Accounting Standards Executive Committee (AcSEC) who did not object to its issuance. Representatives of the AICPA would be pleased to discuss these comments with you at your convenience.

Sincerely,



Frank W. Crawford
Chair
AICPA State and Local Government
Expert Panel



Mary M. Foelster
Director
AICPA Governmental Auditing
and Accounting

cc: State and Local Government Expert Panel
Jay Hanson
Ben Neuhausen
Daniel J. Noll

APPENDIX—COMMENTS AND RECOMMENDATIONS

Use of Certain Phrases. There are a number of phrases used throughout the ED that are subject to potentially inconsistent use or interpretation. This includes use of phrases such as “consistent with” (paragraphs 22(a)(1) and (3), 27, 32(e)(1), and 44(c)(1)), “in certain circumstances” (paragraphs 31 and 43), “on or about” (paragraphs 32(e)(4), 32(f)(2), and 36(e), among others), and “a short time period” (paragraph 36(f)(3)). Without some discussion about what is intended by these phrases, preparers do not have a basis for making judgments and auditors may have difficulty from an audit perspective. Clarification should be provided.

Definition of Derivative Instruments (paragraph 7). “A derivative instrument that is embedded in a financial instrument” as used in this paragraph might be better described as “derivative features” or “features that are constructively a derivative” since many embedded derivatives are not described or thought of as separate “derivative instruments.”

Normal Purchases and Sales Contracts (paragraphs 13 and 81). These paragraphs would exclude normal purchases and sales contracts from the scope of the proposed statement. We had several points of confusion in this area. First, the normal purchases and normal sales exclusion proposed in paragraph 13 of the ED requires physical delivery if the contract is to be excluded. But in the electric power arena, in which governments are both consumers and suppliers, there is a problem with bookouts whereby instantaneous sales and/or purchases may occur. In these circumstances, even though a physical flow of energy does not take place, a transaction does occur. The ED does not discuss this issue, which has proven problematic in the non-government arena. We believe similar problems will arise with governments, unless the Board includes discussion of this issue. One option would be for the GASB to state that governmental entities that are party to derivative contracts designed to accomplish the ultimate purchase or sale of power shall be afforded the normal purchases and sales exception unless evidence suggests that the contract notional exceeds that needed for physical consumption and therefore indicate that they are speculating on market price changes. Second, paragraph 81 suggests that a commodity swap would meet the definition of a normal purchase/sale scope exception. We would not have come to this conclusion since the swap usually does not result in actual delivery of a commodity. Further, this is different than what is implied in illustration 7 which illustrates a cash flow hedge that uses a commodity swap. It appears that in paragraph 81 and illustration 7, the instrument described is actually a commodity forward, not a commodity swap (see related comment below on illustration 7). The Board should more clearly articulate its intent in this area. Third, paragraph 13 states that the determination of whether a contract meets the normal purchases and sales contracts exception depends partially upon whether a government had entered into such a contract in the past. What if it is their first contract? The Board should clarify how a government would demonstrate past practice. For example, are there a practical number of contracts that would indicate past practice?

Appropriate Accounting for Terminations in Conjunction with Refundings (paragraphs 18 and 53). This paragraph discusses the accounting treatment when the termination events described in 53(a)–(d) occur. It is unclear as to the appropriate accounting for the termination of hedging derivatives in conjunction with debt refundings. If a refunding takes place, how does the deferral account impact the gain or loss on a refunding? Based on paragraphs 18 and 53, it appears the deferral would be written off (recognized as investment income). However, we believe the deferral may be more appropriately included in the gain or loss on refunding calculated in accordance with GASB Statement No. 23, *Accounting and Financial Reporting for Refundings*

of Debt Reported by Proprietary Activities as the termination of the hedge (i.e., interest rate swap) on the refunded debt was part of the economic decision to refund the underlying debt.

Redesignation of a Hedging Derivative (paragraphs 19(a) and 53). It appears the proposed standard only allows derivatives to be hedged against specific debt instead of forecasted interest payments of any outstanding debt. Therefore, the inability for a derivative to be “redesignated” seems to be a hardship, especially when one considers how often debt is refinanced or new debt is obtained in a governmental environment. We recommend that the Board allow the redesignation of hedging derivatives because there are situations where hedged variable rate debt is replaced with cheaper variable rate debt with the same maturity date. Under either the dollar-offset or regression methods the original derivative might be effective in hedging the new debt.

Clarification of Expected Transaction Terminology (paragraph 19). The first sentence of paragraph 19 states “When the expected transaction occurs (paragraph 53(e)), the disposition of the deferral balance depends on whether the hedged expected transaction results in a financial instrument or a commodity.” This language is inconsistent with paragraph 19(b) which states “If the expected transaction is associated with a commodity, the balance of the deferral account should be eliminated by reporting the balance as an adjustment to the actual transaction.” This should be clarified.

Expected Transaction Deferral Amortization (paragraph 19(a)(2)). We recommend the Board consider providing specific guidance on the accounting for amortization of the deferral balance for expected transactions as contemplated in paragraph 19(a)(2) when the government is not re-exposed to the hedged risk. The guidance currently suggests the deferral should be amortized over the “life of the debt as an adjustment of interest expense.” Should this be amortized using the effective interest or straight-line method?

Support for Hedge Accounting Conclusion (paragraph 22). Based on the guidance in this paragraph, it is our understanding that hedge accounting is not an option, but must be applied if the hedge is effective. This position is fairly generous compared to the tests and documentation required of non-government entities and we assume that the difference is based on the Board’s belief that hedge accounting is generally most appropriate for governments. The final standard could be improved by making an explicit statement of this seemingly guiding principle and the Board’s reasons that support this conclusion. The language in paragraph 94 is much clearer in this regard and the Board could consider bringing some of the language in paragraph 94 to the standard portion of the final document.

Partial Term Cash Flow Hedge (Paragraph 22(a)(3)). This paragraph states that for a derivative instrument to be “associated” with a hedgeable item, consideration should be given to whether the term or time period of the derivative instrument is consistent with the term or time period of the hedgeable item. This would appear to suggest that partial term cash flow hedges are not permitted. However, in describing a criterion for determining whether an interest rate swap should be considered effective under the consistent critical terms method, paragraph 32(e)(2) appears to permit partial-term hedges. This inconsistency led us to question the Board’s intent in this area and therefore, further clarification should be provided.

Evaluating Effectiveness (paragraph 26). As indicated in paragraph 26(a), a potential hedge is first evaluated under the consistent critical terms method, at least during the initial period of a

hedging relationship. If the consistent critical terms method does not lead to a conclusion of effectiveness, a quantitative method must be used. The ED does not include any parameters around when it may not be appropriate for certain of the quantitative methods to be used. Without additional guidance, there may be an opportunity for governments to select a particular quantitative method to obtain a desired answer. For example, if a government fails the consistent critical terms method because the notional of the derivative does not match the principal of the hedged item, the government will always fail the synthetic instrument method, which also requires the notional and principal to match. By applying the synthetic instrument method after the consistent critical terms method fails, it appears as though the government may conclude the hedge is not effective, even though application of the regression method might lead to the conclusion the hedge was effective. Was this the Board's intent? If so, it seems inconsistent with the Board's general principle that hedge accounting should generally be applied if a potential hedging derivative instrument is effective. It would be useful to have a paragraph in the Basis for Conclusions discussing the rationale for allowing different methods of assessing effectiveness, stating when the different methods would be appropriate or, alternatively, describing a scenario where a particular method may not be appropriate. Additional guidance in this area will help governments apply these tests in a consistent manner.

Consistent Critical Terms Method (paragraph 32(a) and (d)). Paragraph 32(d), which describes a required criterion for the consistent critical terms method, states “[t]he benchmark interest rate may not be multiplied by a coefficient . . . or an addition or subtraction of a constant, such as 10 basis points.” This restriction appears easy to circumvent by adjusting the rate on the fixed-rate leg of the swap to offset the elimination of any margin on the swap's variable-rate leg. Therefore, the Board should consider eliminating the restriction from the standard. Also, with regard to paragraph 32(a), we were unclear whether the standard would permit hedging a portion of an instrument.

Forward Contracts (paragraphs 33(c) and 45(c)). These paragraphs appear in a listing of required effectiveness criteria. However, they appear to be out of context in that they discuss how to measure effectiveness. We believe they would be better placed in the section of the standard “Methods of Evaluating Effectiveness.”

New Market Conditions (paragraphs 35 and 47). We believe that the phrase “new market conditions” in paragraphs 35 and 47 may be interpreted too broadly by readers and encourage some to think there is an easy way out of hedge accounting. This potential is further reinforced by illustration 4 in which an otherwise effective hedge is declared to be ineffective without further explanation or reference back to the phrase “new market conditions.” The converse may also be true. Paragraph 35 notes that “In such cases, evaluation methods or data that incorporate fair value information, and therefore reflect the impact of the new market conditions *may* be employed to see if the criteria continue to be met.” Use of “may” seems to allow an entity to ignore compelling evidence that new market conditions suggest that the hedging derivative will not be effective in future periods, and continue to use quantitative methods that mechanically produce an answer (i.e., the hedge is effective) contradicted by new evidence. Without further clarification of the intent of these paragraphs and the phrase “new market conditions” potential abuse by those who prefer a particular accounting answer could occur.

Synthetic Instrument Method (paragraph 36(f)). The description of “actual synthetic rate” in paragraph 36(f) would require the spread to index on the hedged item to be mirrored in the derivative which, if the swap has an initial fair value of zero, is of little to no economic

consequence. Was this intended? See also our comment below on illustrations 3 and 4 which describes our concern regarding the potential for manipulation using this method.

Written Options (paragraphs 57 and 122, illustrations 10 and 11). Based on the guidance provided in these paragraphs, it was unclear whether written options could ever be a hedging derivative instrument. In addition, illustrations 10 and 11 regarding written options do not discuss hedging which implies that hedge accounting is not available. Although it is unusual for written options to be used in hedging applications, it is not unheard of. The Board should explain whether hedge accounting is ever appropriate for written options and, if so, under what circumstances. Further, similar to our comment on hybrid instruments below, the Board should better define the term “closely related” as used in paragraph 57 of the ED.

Regression Analysis Method (paragraphs 38–40 and illustration 6). We believe the guidance on regression analysis has been improved since the PV. However, we recommend that input from a statistician be sought by the Board before finalizing the guidance. For example, it is our understanding that there are alternatives to the F-statistic that may provide equally relevant information (e.g., the T-statistic). As another point, illustration #6 illustrates the regressing of levels of rates (68% of LIBOR payments versus SIFMA swap index payments). We are aware of published guidance that strongly cautions against populating regressions with *levels* of rates or payments instead of *changes in* rates or payments. Statisticians often have strong opinions on the *levels versus changes* debate, and the ED does not touch on that debate. The concern is that regressions solely based on levels of rates or payments may result in false positives (leading one to believe a hedge will behave as effective when it actually will not). Hedges work when derivative cash flows *change* in a correlated manner with the way hedged cash flows *change*. Considering all of this and as noted in our comment letter on the PV, the Board should include a statement in the final standard encouraging preparers to consult with a statistician if they use a statistical model such as regression analysis.

Hybrid Instruments (paragraphs 54–57). Accounting for hybrid instruments will likely pose difficulties for preparers. The term “closely related” as used in paragraphs 55(a) and in illustration 5, will make it more challenging in that the ED does not include any discussion as to how one determines whether items are closely related. In illustration 5, the statement is made that “[t]he borrowing is not closely related to the swap” but there is no discussion as to how that determination is made. We encourage the Board to more clearly define the term “closely related” and to leverage off the previous efforts of the FASB, particularly the numerous FASB 133 Implementation Issues that address embedded derivatives.

Synthetic Guaranteed Investment Contracts (paragraph 58). The “fully benefit-responsive” definition in this paragraph is not exactly the same as in FSP SOP 94-4-1. We are not clear why the Board chose a different definition and recommend that the Board explain its intent. While a difference may be appropriate depending on the Board’s intent, we are unsure how it will impact the accounting in other areas, especially for employee benefit plans. Third-party administrators service both governmental and non-governmental plans and this difference in definition could cause confusion to those who would otherwise not be impacted by derivative accounting.

Notes to the Financial Statements—Embedded Derivatives (paragraphs 59–69). As noted in the introductory section of this letter, we believe one of the shortcomings of the ED is that very little guidance is provided on embedded derivatives. That concern extends into this section of the ED

on disclosures. It is unclear exactly which disclosures are required for embedded derivatives. This should be clarified in the final document.

Notes to the Financial Statements—Use of Pricing Service (paragraph 60, footnote 9 and paragraph 64, footnote 10). These footnotes provide an exception to disclosing certain information if a pricing service is used. It is our view that management has the responsibility for all of the information presented in its financial statements, including information provided by a pricing service. Therefore, we recommend that footnotes 9 and 10 be deleted.

Credit Risk Disclosures (paragraph 64(a)(3)–(6)). We believe the required disclosures in paragraph 64(a)(3)–(6) would not be cost effective for preparers and suggest that they be deleted from the final standard. There also appears to be an inconsistency between the requirements of this paragraph and that of paragraph 59. Paragraph 59 allows presentation of instruments in the aggregate and the requirements within this paragraph are oriented to individual instruments. It is unclear as to how preparers with many instruments will be able to meet the requirements within this paragraph. We recommend that further clarification be provided.

Netting Arrangement Disclosure (paragraph 64(a)(5)). If the Board does not take our previous recommendation to delete this disclosure, we believe it needs clarification. This paragraph states that when a government has entered into netting arrangements that the government should disclose the aggregate fair value of hedging derivative instruments in net asset positions net of collateral. It is unclear as to whether the collateral should be measured at cost or fair value when netting with the fair value of the derivative. We assume that the Board’s intent is for the current fair value of the collateral to be used. If that assumption is correct, it then leads to other issues relating to determining fair value when the collateral is not a financial instrument (for example, a building). The Board should clarify if fair value is the appropriate measure for collateral and, if so, address issues relating to determining fair value for non-financial instrument collateral.

Investment Derivative Disclosures (paragraph 67). This paragraph would require disclosures for investment derivatives that go beyond what other GASB standards currently require. We believe that the disclosures already required by other GASB standards are adequate and that the incremental disclosures required in this paragraph are not necessary.

Transition Guidance Needed for GASB 20 Entities (paragraphs 70 and 71). GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended, paragraph 7, provides that enterprise funds may elect to apply *all* FASB pronouncements issued after November 30, 1989, *except for* those that conflict with or contradict GASB pronouncements. The GASB Web site goes on to indicate that FASB 133 would apply “in part” to those entities that have taken the paragraph 7 election and have derivative transactions. As noted in our letter on the PV, the Board should address in the transition guidance provided in the final standard a discussion of what actions an entity that has reported its derivatives using the parts of FASB 133 that do not conflict with GASB standards would have to take upon issuance of a final GASB derivative standard.

Fair Value Hedge Versus Cash Flow Hedge (paragraph 90). Similar to our comment on illustration 2 below, this paragraph provides an example where a government may establish a *fair value hedge* by purchasing an interest rate cap in anticipation of the issuance of fixed-coupon bonds. In our view, the example provided in this paragraph appears to be a *cash flow*

hedge, even though the debt that will be issued will be fixed-rate debt. This should be clarified. It should also be noted that, if the Board agrees this is a cash flow hedge, there are no illustrations of the accounting for a fair value hedge.

Synthetic Instrument Method (paragraphs 104 and 106). The last sentence of paragraph 104 states: “The Board clarifies in this Statement that only a hedge of overall cash flows can be assessed for effectiveness using the synthetic instrument method.” We believe the standard itself could be clearer by including this point in paragraph 36, in addition to this paragraph in the Basis for Conclusions.

Further, the range for the actual synthetic rate of 90 to 111 percent being effective is not strongly supported in paragraph 106 of the Basis for Conclusions. Governments with weaker credit ratings must pay higher rates on their issued debt than their peers with stronger ratings but the all-in fixed rate on their swaps will likely never match, and will be less, due in part to the different credit risk on swaps (which is two directional) and debt (which is one directional). Such governments may have difficulty achieving the acceptable range for the synthetic rate because the fixed pay rates they are able to command will logically be the most distant from the fixed rates of an at-market interest rate swap (which will likely require the government to post collateral in order to result in lower all-in swap rates). Perhaps this is the intention of GASB, to make less creditworthy governments less likely to achieve hedge accounting and/or necessitate the posting of additional collateral to achieve an acceptable synthetic rate. If so, this should be explained in the Basis for Conclusions.

Regression Analysis (paragraph 110) Not all regression analysis is of historical data. Any data set can be analyzed by regression including currently observed data, pro forma data, or simulated data. However, this paragraph implies that regression is limited to historical data. This should be clarified.

Regression Analysis Method (paragraph 117). We agree that the slope coefficient should be between -1.25 and -0.80, but these slope coefficients only make sense if the hedge ratio is 1.00 (one unit notional of derivative for each one unit notional of hedged item). For example, a regression analysis of historical full (taxable) LIBOR swap rates versus SIFMA swap rates would be expected to have a slope coefficient within 80 percent and 125 percent of 0.68, reflecting the desirable notional mismatch of .68 units notional of a full LIBOR swap relative to 1.00 units notional of a tax-exempt bond issuance. Accordingly, the ED should note that all regression coefficient slopes should be contemplated in comparison to the actual hedge ratio in use. If a \$68,000,000 notional full LIBOR-based swap is paired with a \$100,000,000 notional SIFMA-based debt issuance, the “ideal” slope of the regression line is 0.68, reflecting an exact match with the actual notional hedge ratio ($\$68,000,000/\$100,000,000$). If on the other hand, a \$100,000,000 notional “68 percent of LIBOR-based” swap is paired with a \$100,000,000 notional SIFMA-based debt issuance, which is economically identical to the pairing in the first example provided above, the “ideal” slope of the regression line is indeed 1.00.

Termination of Hedge Accounting (paragraph 119). This paragraph states that the “elimination of the deferral account depends on whether the hedgeable item is an asset, liability, or expected transaction.” This statement seems inconsistent with paragraph 18 which states that the balance in the deferral account should be recognized on the change statement when the hedge is terminated. This should be clarified.

Illustration #1. We believe that the “Total Payments” column is unrealistic as there is a distinct basis difference between the variable-rate bonds and the SIFMA swap index which in our experience very rarely stays consistent. Further, we also believe there needs to be a basis risk disclosure with this hedge transaction.

Illustration #2. This Interest Rate Lock example appears to be a cash flow hedge, and not a fair value hedge as the illustration is titled. The fixed-coupon bonds have not yet been entered into during the time that the hedge is in place and that is why we believe the illustration title should be changed to identify it as a “Cash Flow Hedge.” Further, one deficiency of FASB 133 is that it did not illustrate use of the effective interest method to amortize in the effect of a hedge. The difficulty lies in the fact that all illustrations of the effective interest method assume that a debt instrument was issued at a premium or a discount; in this case, the debt will be at par. Presumably one must act as if the effect of the hedge adds a premium or subtracts a discount. This should be clarified. Finally, we had difficulty in determining how interest expense of \$67,728 was calculated. An explanation should be provided to add clarity to this illustration.

Illustrations #3 and #4. Illustrations 3 and 4 show an example of the synthetic rate calculation. It appears as though the results of these effectiveness calculations could be manipulated by increasing or decreasing the 78 basis points margin included in the variable leg of the swap. If governments should generally be using hedge accounting when a hedging relationship exists (see related comment on paragraph 22), governments should not be able to affect whether hedge accounting is required simply by adjusting nominal terms of a potential hedging derivative.

Illustration #4. We were confused by the key point of this example. In this example, an acceptable synthetic rate was achieved *through June 30, 20X3*, but the government determines that due to changes in tax rates the hedge will not meet the criteria for effectiveness in the future. Accordingly, the city determines that the swap is not a hedging instrument for the *fiscal year ended June 30, 20X3*. We would have presumed that the swap is a hedging instrument through June 30, 20X3, and that hedge accounting will not be applied as of July 1, 20X4, and for the *following year*. This example needs to pinpoint the date at which hedge accounting stops. In our view it seems inappropriate to effectively stop hedge accounting retroactively to the beginning of the year (July 1, 20X2), when the entire year through June 30, 20X3 proved to be effective.

Illustration #5. In the second paragraph under “Assumptions” it states interest is accrued at 5.15%. We assume that this is the “discount rate” used to present value the payment received upfront. This should be clarified.

Illustration #6. We recommend that this illustration be clarified by adding a statement similar to the following: “While the synthetic instrument method is available, the entity chooses regression analysis for effectiveness testing.” See also our related comment above in the comment titled, “*Regression Analysis Method (paragraphs 38–40 and illustration 6).*”

Illustration #7. As noted in our comment above on the normal purchase and sales contracts, it appears that this illustration is actually illustrating a commodity forward and not a commodity swap. We believe that this illustration will be useable if the Board changes the commodity swap to a commodity forward. Furthermore, this illustration should clarify whether consideration for a normal purchase and sales exception was given for the commodity forward and why the contract in the illustration does not qualify for the exception.

Illustration #8. It seems that in order to apply the synthetic instrument method in this case, the ability to get a quoted forward price is a key factor. If an entity is unable to get a quoted forward price on the date the derivative is entered into, then it appears this method is not available. This should be clarified. Also, understanding the calculation of the “synthetic fixed price per gallon” was not intuitive and should be explained more clearly.

Illustration #9. This example shows the hedge losing effectiveness from a dollar offset point of view at the end of its life, but there is no discussion of this and in fact, the journal entries appear to support hedge accounting up until the end. Another weakness in this illustration is that there are no dates at which the journal entries are posted. They simply occur “during” the year being reported, without indicating when during the year such entries would be appropriate. For example, the cash payment on the commodity swap of \$250,000 is implied to be the trigger for the government to record the effect of the hedge (reduction of natural gas fuel expense). Is that the intention?

Illustration #10. Paragraph 122 states that a borrowing in the amount of the intrinsic value of a written option should be accounted for as any other borrowing—measured on an amortized cost basis. We believe this leads to a flaw in illustration 10. Illustration 10 shows that the intrinsic value becomes larger and larger as time passes, increasing the liability that the government must honor as the swaption moves more and more “into the money.” While we agree that this represents a liability, because the illustration sets up the intrinsic value as a borrowing on an amortized cost basis, instead of a fair value basis, the growth of this liability is not accounted for until extinguishment, when the entire loss that built up over a series of several periods is finally recognized. Also, the first paragraph has a sentence as follows: “That is, the written option has intrinsic value at inception as the fixed rate stated in the swaption is greater than the at-the-market rate.” We assume the “at-the-market rate” being referred to is the swap forward rate versus the swap rate at that date (spot) but we recommend this be clarified for users who may not be familiar with this situation.