National Association *of* Bond Lawyers

PHONE 202-682-1498
FAX 202-637-0217
www.nabl.org

601 Thirteenth Street, N.W.
Suite 800 South
Washington, D.C. 20005

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Birmingham, AL

*President-Elect*
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Atlanta, GA

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*Director of Governmental Affairs*
**ELIZABETH WAGNER**
Washington, DC

*Executive Director*
**KENNETH J. LUURS**
230 West Monroe Street
Suite 320
Chicago, IL 60606-4715
Phone 312-648-9590
Fax 312-648-9588

November 21, 2007

Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: Project No. 26-4, Exposure Draft of the Proposed Statement, *Accounting and Financial Reporting for Derivative Instruments*

Ladies and Gentlemen:

The National Association of Bond Lawyers ("NABL") respectfully submits the enclosed response to the Governmental Accounting Standards Board ("GASB") solicitation for comments on Project No. 26-4, Exposure Draft of the Proposed Statement, *Accounting and Financial Reporting for Derivative Instruments*, dated June 29, 2007, (the "Proposed Statement"). The enclosed comments supplement NABL's prior comments relating to the Preliminary Views of GASB on Major Issues related to *Accounting and Financial Reporting for Derivatives*, dated April 28, 2006 (*see* Exhibit I). The NABL comments were prepared by an ad hoc Securities Law subcommittee, chaired by William L. Hirata, of Parker Poe Adams & Bernstein LLP, Charlotte, NC. Members of the ad hoc subcommittee are listed in Exhibit II. As noted in the enclosed response, NABL limits its comments to the areas in which its members are most knowledgeable: the effect of the application of the accounting and financial reporting requirements set forth in the Proposed Statement on the bond issues of State and local governments.

NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance. A professional association incorporated in 1979, NABL has more than 3,000 members and is headquartered in Chicago.

If you have any questions concerning the comments, please feel free to contact me at 205/226-3482 (fclark@balch.com), William L. Hirata at 704/335-9887 (billhirata@parkerpoe.com), or Elizabeth Wagner, Director, Governmental Affairs at 202/682-1498 (ewagner@nabl.org).

Thank you in advance for your consideration of these comments.

Sincerely,

J. Foster Clark

Enclosure

cc: William L. Hirata
Kristin H.R. Franceschi
Teri M. Guarnaccia
Jonathan C. Leatherberry
John M. McNally
Jeffrey C. Nave
Walter J. St. Onge III
E. Tyler Smith
Elizabeth Wagner
Fredric A. Weber

National Association *of* Bond Lawyers

RECOMMENDATIONS
OF THE
NATIONAL ASSOCIATION OF BOND LAWYERS

COMMENTS RELATING TO
GOVERNMENTAL ACCOUNTING STANDARDS BOARD
PROJECT NO. 26-4
EXPOSURE DRAFT OF THE PROPOSED STATEMENT,
*ACCOUNTING AND FINANCIAL REPORTING FOR DERIVATIVE INSTRUMENTS*

NOVEMBER 21, 2007

The following comments are submitted on behalf of the National Association of Bond Lawyers ("NABL") with respect to the Exposure Draft of the Proposed Statement of the Governmental Accounting Standards Board ("GASB") related to *Accounting and Financial Reporting for Derivative Instruments*, dated June 29, 2007 ("Proposed Statement"), and are a follow-up to the comments submitted by NABL relating to the Preliminary Views of GASB on Major Issues related to *Accounting and Financial Reporting for Derivatives*, dated April 28, 2006. NABL's previous comments are attached hereto in Exhibit I.

NABL members provide legal advice to State and local governments as well as users of their financial statements. NABL members are not themselves compilers or users of the financial statements. Accordingly, NABL defers to other organizations for comments on the usefulness and efficacy of the accounting and financial reporting standards described in the Proposed Statement and will limit its comments to the area in which its members are most knowledgeable: the effect of the application of the accounting and financial reporting requirements set forth in the Proposed Statement on the bond issues of State and local governments.

Specifically, NABL believes that if the Proposed Statement is implemented by State and local governments with outstanding bonds, those governments likely will experience "paper" income and losses that do not accurately reflect the operating results of public enterprises for purposes of compliance with bond covenants that are based on operating results.

## Discussion

NABL is concerned that the accounting and financial reporting requirements set forth in the Proposed Statement may significantly impact, either positively or negatively, a State or local government's compliance with outstanding revenue bond covenants and possibly result in misleading disclosure to investors.

**Revenue Bond Covenants**. State and local governments routinely issue revenue bonds, whether directly or for the benefit of conduit borrowers, to finance municipal utilities, airports, convention centers, and other important public infrastructure (collectively referred to as "public

enterprises"). Most public enterprise revenue bonds contain a "Rate" covenant[1] and an "Additional Bonds Test" covenant[2]. The definitions of "net revenues" (or the measures) used in many Rate and Additional Bonds Test covenants are expressly governed by generally accepted accounting principles ("GAAP") "in effect from time to time," rather than to GAAP as "in effect when the bonds are issued." With respect to bond documents governed by GAAP "in effect from time to time," changes in the principles used to determine a State or local government's changes in net assets or other similar change statement measures could affect its compliance with outstanding revenue bond covenants.

Under the changes to GAAP contemplated by the Proposed Statement, unless a hedging derivative instrument issued in conjunction with a public enterprise revenue bond issue remains "effective," changes in fair value during a State or local government's fiscal year would be taken into account in calculating the public enterprise's "net revenues," to the extent that term is governed or influenced by GAAP. In a given year, some public enterprises will reflect increased net revenues, and other public enterprises will reflect decreased net revenues, solely as a result of implementing the contemplated changes to GAAP. The result of such a decrease of net revenues can cause a public enterprise to fail its Rate covenant (which may trigger default proceedings under the bond documents) or fail its Additional Bonds Test covenant (which may preclude the issuance of additional parity lien bonds). NABL does not believe this result is the intended consequence of the Proposed Statement. For instance, if the contemplated changes to GAAP set forth in the Proposed Statement were to require greater gross revenues for State and local governments to comply with bond covenants, those governments may be forced to increase their rates and charges or may be forced to pursue refundings or consent solicitations in order to obtain covenant relief. Similarly, if these contemplated changes enable State and local governments to comply with bond covenants with less gross revenues than otherwise required, the creditworthiness of outstanding bonds may be adversely affected until the bonds mature, with consequent loss to bondholders who trade the bonds before maturity or suffer a resulting default.

**Consistency with Prior GASB Positions on Governmental Debt**. GASB recognized in its paper entitled "*Why Governmental Accounting and Financial Reporting Is – and Should Be – Different*" that State and local governments are fundamentally different than for-profit business enterprises in several important ways. These differences justify different treatment of accounting items from time to time. An example of different treatment relates to the treatment of the economic gain resulting from the refunding of State and local governmental bonds during the period of extinguishment:

> When determining how these differences should be accounted for in a governmental environment (for proprietary funds), the decision was made that the differences should be deferred and recognized as adjustments to interest expense. . . . This was different from the then-applicable business enterprise accounting standards because it was believed that immediate recognition would produce

[1] The "Rate" covenant generally requires the establishment and collection of rates for goods or services sufficient to pay (i) the annual operating expenses, (ii) a multiple of debt service on the parity and senior obligations issued by the public enterprise and (iii) debt service on subordinate obligations.

[2] The "Additional Bonds Test" covenant generally conditions the issuance of additional parity or senior revenue bonds on realizing or projecting adequate annual "net revenues" at a specified multiple of the outstanding and proposed bonds.

operating results in the period the debt is refunded that were less decision-useful for users of governmental financial reports.

Thus, in situations where State or local governmental debt is involved, GASB has recognized that immediate recognition of results (*e.g.,* immediate recognition of investment income or loss upon an ineffective debt-associated hedging derivative instrument) might not be "decision-useful." NABL recommends that the economic gain or loss resulting from derivative instruments entered into in connection with State and local governmental debt issuances be treated in a similar manner—*i.e.* that such gain or loss be deferred (or the derivative instrument treated as an effective hedge). Immediate recognition of such gain or loss may otherwise skew those governments' financial reports and adversely affect bond covenants that are computed based on such financial reports.

## Recommendations

To mitigate the impact of the implementation of the Proposed Statement on bond covenants, NABL recommends that GASB maintain the status quo for all derivative instruments that are entered into before the effective date of the Proposed Statement by exempting them from financial statement disclosure and by requiring appropriate note disclosures for all derivative instruments, including grandfathered instruments. This exemption would permit State and local governments to assess the potential impact of derivative instruments on their financial statements prospectively (rather than to retroactively discover consequences not contemplated at the time the derivative instrument was entered into).

If GASB does not "grandfather" existing derivative instruments from treatment under the Proposed Statement, then NABL recommends that GASB implement the following procedures:

1. GASB should permit a State or local government to retroactively declare its hedging intent for existing derivative instruments to clarify which of its derivative instruments are "investments" and which are "hedges" at any time prior to the issuance of the first financial statements reflecting the proposed accounting change.

2. GASB should permit the treatment of hedging derivative instruments entered into in connection with a State or local government's issuance of debt as "effective" until either termination or the associated debt is retired.

3. GASB should permit the treatment of "qualified hedges" (as defined in Treasury Department regulations pertaining to State and local governmental bonds) as effective derivatives until termination.

## Closing

NABL believes that if the Proposed Statement is implemented by State and local governments with outstanding bonds, those governments likely will experience "paper" income and losses that do not accurately reflect the operating results of public enterprises for purposes of compliance with bond covenants that are based on operating results.

NABL's recommendations set forth herein are designed to mitigate that impact.  NABL welcomes the opportunity to be of further assistance, if appropriate, in achieving the clarity, certainty and administrability needed for this important issue.

**EXHIBIT I**

National Association *of* Bond Lawyers

PHONE (202) 682-1498 601 THIRTEENTH STREET, NW
FAX (202) 637-0217 SUITE 800 SOUTH
WWW.NABL.ORG WASHINGTON, D.C. 20005

COMMENTS
OF THE
NATIONAL ASSOCIATION OF BOND LAWYERS
regarding
PRELIMINARY VIEWS OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD
ON MAJOR ISSUES RELATED TO
ACCOUNTING AND FINANCIAL REPORTING FOR DERIVATIVES

The following comments are submitted on behalf of the National Association of Bond Lawyers (NABL). The comments relate to the Preliminary Views of the Governmental Accounting Standards Board (GASB) on Major Issues related to Accounting and Financial Reporting for Derivatives, dated April 28, 2006 (PV). The comments were prepared by an ad hoc subcommittee of the NABL's Securities Law Committee. The members of the ad hoc subcommittee are listed below.

NABL members provide legal advice to state and local governments as well as users of their financial statements. NABL members are not themselves compilers or users of the financial statements. Accordingly, NABL defers to other organizations for comments on the usefulness and efficacy of the accounting and financial reporting changes described in the PV. NABL limits its comments to the areas in which its members are most knowledgeable: the possible impact of the described changes on compliance with outstanding bond covenants, including both financial covenants and continuing disclosure obligations.

## Background

**Bond Covenants**. Many state and local governments have issued (and in the future will issue) substantial amounts of revenue bonds to finance municipal utilities, airports, convention centers, and other important public infrastructure. In doing so, they typically enter into covenants to set and collect rates for goods or services sufficient to pay annual operating expenses and debt service on the revenue bonds (and parity and senior obligations) with a specified cushion. In addition, state and local governments typically enter into covenants that condition their right to issue additional parity or senior revenue bonds (or to take certain other actions) on realizing or projecting adequate annual net revenues to pay annual debt service requirements with a similar or higher cushion. In contrast to typical corporate financings, governmental revenue bond covenants seldom refer to capitalization ratios or other balance sheet items, except for occasional liquidity covenants.

**Rationale for Covenants.** Unlike private business enterprises, governments do not exist to maximize the value of their organizations, and they may face political resistance to increasing rates for essential public services. Accordingly, revenue bond rate covenants (and additional bond tests) are designed to assure that the government will have adequate annual revenue to operate and

maintain its revenue-producing assets and to pay debt service on the bonds (and parity and senior obligations). On the other hand, bondholders typically are less concerned by the data reflected in a government's balance sheet and, except for occasional liquidity covenants, seldom require covenants based on measures reflected in a balance sheet. This is true because (i) the pledged revenues are usually generated by enterprises performing essential governmental functions for which there is no effective competition, permitting the government to raise rates as necessary to pay debt service, (ii) most of the government's assets are required to perform its governmental functions and, accordingly, are not available for trade or sale, and (iii) governments are not subject to liquidation proceedings in bankruptcy.

**Effect of GAAP on Covenant Compliance.** In revenue bond covenants, descriptions of net revenues are typically similar to earnings of for-profit enterprises before income tax, depreciation, and amortization (commonly referred to as "EBITDA"), but they vary greatly among states, government and enterprise types, and specific governmental issuers. The definitions of net revenues (or the measures used in the definitions) are sometimes stated to be governed by generally accepted accounting principles (GAAP). In these cases, to minimize divergence between financial and legal accounting over time, the operative provisions sometimes refer to GAAP as in effect from time to time, rather than to GAAP as in effect when the bonds are issued. Even when the definitions of net revenues (or the measures used in the definitions) are not stated to be governed by GAAP, GAAP may be referenced in resolving ambiguities presented by the definitions. Accordingly, changes in the principles used to determine a governmental unit's changes in net assets or other similar change statement measures could affect state and local government compliance with outstanding revenue bond covenants.

**Permanence of Covenants.** State and local government revenue bonds often are not callable for a period of years and, under federal income tax rules, often may not be refunded with other tax-exempt obligations until they are or soon will be subject to redemption at the option of the issuer. Consequently, the bonds often may not be economically refunded to modify or terminate burdensome covenants. In addition, governmental revenue bonds typically are widely sold and held. Accordingly, consent solicitations to secure bondholder agreement to modify covenants are generally infeasible or, at least, very expensive and time-consuming. As a result, if the contemplated changes to GAAP sometimes require greater gross revenues for state and local governments to comply with bond covenants, the governments may be forced to increase their rates and charges to do so or may be forced to pursue expensive, uneconomic refundings or consent solicitations in order to obtain covenant relief. Similarly, if the contemplated changes enable governments to comply with bond covenants with less gross revenue than otherwise required, the creditworthiness of outstanding bonds may be adversely affected until the bonds mature, with consequent loss to bondholders who trade the bonds before maturity or suffer a resulting default.

**Disclosure to Investors.** Governmental issuers almost universally publish their financial statements as part of the disclosure documents they use to market their bonds to investors. In addition, to enable the underwriters of public offerings of their bonds to comply with Rule 15c2-12 adopted by the United States Securities and Exchange Commission (SEC), governmental issuers regularly undertake to file annual financial statements with nationally recognized information services during the term of the bonds. Both to comply with state and federal securities laws and to be fair to investors (many of whom are often constituents of the government), governments take great care to avoid misleading statements when they publish or file their financial statements or other data in a manner accessible to investors.

## Comments

**1. Impact on Bond Covenants.** Under the changes to GAAP contemplated by the PV, unless a derivative contract is a qualified hedge, changes in the value of the contract during a government's fiscal year likely would be taken into account in calculating its enterprise net revenues, to the extent that term is governed or influenced by GAAP. In addition, if a derivative contract loses its status as a qualified hedge during its term, deferred changes in its value from inception would be taken into account. Unlike most other components of net revenues, the change in value would result in current year recognition (as gain or loss) of the present value of expected net payments or receipts over the entire remaining term of the contract. Accordingly, a change in current or expected interest rates or commodities prices could result in an impact on net revenues in the current year that is many times the actual current cash flow impact on the government. For valid governmental purposes, governments often enter into derivatives contracts (such as interest rate "basis" swaps and fixed receiving interest rate swaps) that do not qualify as hedging derivatives contracts, and under the contemplated changes to GAAP, even qualified hedging contracts may lose their qualification as such over time. Unless all of a government's derivatives contracts are qualified hedges, the contemplated change in GAAP could affect a government's ability to comply with rate covenants and additional bonds tests in years in which the values of its non-hedging derivatives contracts change much more substantially than the annualized impact of the changes in prevailing interest rates or commodities prices. This result could adversely impact either bondholders or governments, depending on the circumstances, and could defeat the expectations of both governmental issuers when they issued bonds and entered into the derivatives contracts and investors when they purchased bonds.

For example, suppose a local government has issued variable rate bonds and entered into a fixed paying interest rate swap agreement to effectively fix its net interest liability, but, due to changes in federal income tax laws, market conditions, or other causes, the swap is no longer an effective hedging contract under the contemplated changes to GAAP. Suppose, also, that the government's bond covenants use (or are influenced by) GAAP in defining net revenues. If, due to a possibly modest change in either prevailing interest rates or the slope of the yield curve, the value of the swap were to decline substantially in a year, the government's net revenues in that year would be reduced by an amount far greater than the expected impact on recurring net annual cash flow available to pay current or future debt service. As a result, the government might breach its rate covenant for that year or lose its ability to issue additional parity revenue bonds to finance needed public improvements, even though its actual ability to meet debt service requirements annually is not materially affected. In contrast, if, due to a comparably modest, but opposite change in prevailing interest rates, the value of the swap were to increase materially in a year, the government's net revenues in that year would be increased by an amount far greater than the expected improvement in the government's recurring annual revenue available to pay current or future debt service. As a result, the government might comply with a rate covenant that it would otherwise have breached or be able to issue additional parity revenue bonds that it otherwise may not be able to issue in compliance with bond covenants.

NABL recommends that GASB explore alternative accounting treatments for non-hedging derivatives contracts that would not have a disproportionate impact on the net revenues used by governments in measuring bond covenant compliance, at least where the government's intent is to hold the derivative contract for its term. For example, GASB could consider a proposal to modify GAAP so that (1) if a government intends and is able to hold a derivative contract to maturity, fluctuations in the fair value of the contract would not be reflected in its change statements, but rather

would be deferred, or (2) a government would recognize only the annualized impact of the change in value of a derivative that is not a qualified hedging contract. Alternatively, GAAP could elect not to propose a change to existing GAAP principles. If GASB chooses to propose a change to the principles for accounting for derivative contracts and does not take steps to reduce the disproportionate impact on change statements from the principles contemplated by the PV or the frequency with which those principles would apply, GASB should at least consider treating all pre-effective date derivatives contracts as qualified hedging contracts.

2. **Hedging Contract Exception.** Under the contemplated change in GAAP, to qualify a derivative contract as a hedging contract, a government would have to declare that it entered into the contract to hedge a hedgeable liability or asset. It is not clear from the PV whether the government may declare its intent after it has entered into the derivative contract if the hedged liability or asset already existed at that time. The changes to GAAP are proposed to be applied retroactively from the beginning of the earliest reported year. Accordingly, the changes could apply to derivatives contracts executed before the changes become effective (or were even described in the PV or proposed). GASB should therefore clarify that a government may declare its hedging intent to enter into previously executed derivatives contracts at any time prior to the issuance of the first financial statements reflecting the proposed accounting change, in addition to the other times described in the PV. Otherwise, many outstanding derivatives contracts could be treated as non-hedging contracts (with consequent impact on compliance with revenue bond covenants), even when governments have the intent to hedge a hedgeable asset or liability and have, therefore, entered into effective hedges.

3. **Disclosure Risks.** If a government were to recognize a derivative contract's full change in value in its current year change statement, the change statement might overstate or understate the annualized impact of the value change on the government's overall financial performance, which (based on covenants negotiated with investors) appears to be the data of most interest to investors. Given the importance of financial statements in making disclosure to investors, applying GAAP should result in financial statements that make fair disclosure without the need for explanatory or pro forma supplemental statements.

## Summary

1. **Avoid Unexpected Impact on Covenant Compliance.** If the value of a state or local government's non-hedging derivatives contracts were to increase or decrease substantially in a year, the contemplated changes in accounting for the contracts could affect, positively or negatively, that government's compliance with outstanding revenue bond covenants, in each case to an extent not contemplated by the government when it entered into the covenants or outstanding derivatives contracts or by investors when they purchased the government's bonds. GASB should consider this impact in determining whether to propose the contemplated changes in GAAP for comment. If appropriate, GASB should explore alternative accounting treatments that would avoid or reduce this potential effect on covenant compliance.

2. **Grandfather Outstanding Derivatives Contracts.** If GASB proposes the contemplated change in GAAP for comment, it should clarify that a state or local government may declare its hedging intent (in entering into previously executed derivatives contracts) at any time prior to the issuance of the first financial statements reflecting the proposed accounting change, in addition to the other times described in the PV.

August 4, 2006

Members of the Ad Hoc Subcommittee Regarding the Preliminary Views of the Governmental Accounting Standards Board on Major Issues Related to Accounting and Financial Reporting for Derivatives:

Fredric A. Weber, Chair
Kristin H. R. Franceschi
William L. Hirata
Jonathan C. Leatherberry
John M. McNally
Walter J. St. Onge III
Elizabeth Wagner

National Association *of* Bond Lawyers

# EXHIBIT II

## NABL Ad Hoc Subcommittee Members

Project No. 26-4, Exposure Draft of the Proposed Statement, *Accounting and Financial Reporting for Derivative Instruments*

William L. Hirata, Chair
Parker Poe Adams & Bernstein LLP
Charlotte, NC
(704) 335-9887
billhirata@parkerpoe.com

Kristin H.R. Franceschi
DLA US LLP
Baltimore, MD
(410) 580-4151
kristin.franceschi@dlapiper.com

Teri M. Guarnaccia
Ballard Spahr Andrews & Ingersoll, LLP
Baltimore, MD
(410) 528-5526
guarnacciat@ballardspahr.com

Jonathan C. Leatherberry
Vinson & Elkins LLP
Dallas, TX
(214) 220-7751
jleatherberry@velaw.com

John M. McNally
Hawkins Delafield & Wood LLP
Washington, DC
(202) 682-1480
jmcnally@hawkins.com

Jeffrey C. Nave
Foster Pepper PLLC
Spokane, WA
(509) 777-1601
navej@foster.com

Walter J. St. Onge
Edwards Angell Palmer & Dodge LLP
Boston, MA
(617) 239-0389
wstonge@eapdlaw.com

E. Tyler Smith
Haynsworth Sinkler Boyd, P.A.
Greenville, SC
(864) 240-4543
tsmith@hsblawfirm.com

Elizabeth Wagner
National Association of Bond Lawyers
Washington, DC
(202) 682-1498
ewagner@nabl.org

Fredric A. Weber
Fulbright & Jaworski L.L.P.
Houston, TX
(713) 651-3628
fweber@fulbright.com