

GASB Director of Research and Technical Activities

Regarding: Recognition of Elements of Financial Statements and Measurement Approaches
Due : 9- 30- 2011
Project : 3-20
Comments: Dr. Joseph S. Maresca CPA, CISA

Colleagues,

Thank you for the opportunity to critique this evolving guidance. Details follow:

Background

A measurement approach is an extensive concept which seeks to determine whether or not an asset or liability presented in a financial statement should be (1) reported at an amount that reflects fairly the asset value at acquisition or the liability incurred or

(2) re-measured and reported at an amount that reflects the value at the date of the financial statements. The preliminary views identify characteristics of assets or liabilities that would indicate from a conceptual viewpoint when each measurement approach would be appropriately applied for purposes of future standards formulation and implementation .

Outflows not meeting the definition of an asset are related to government future services or spending. Inflows of resources not meeting the definition of a liability are related to future spending. There may be items not previously recognized as assets in the financial statements (future resources) .

Unfunded or underfunded liabilities is an area of concern for government policy-making because the determination of the periodic budgets must have an element of certainty. Adding future unfunded services can be problematic in determining the overall financial position of the government because the overall mission keeps changing.

Critique:

Initial transactions involve a date-based measurement amount assigned when the asset is acquired or the liability is assumed. Current financial statement data based measurements involve the remeasurement of an asset or liability as of the financial statement date including the fair value of current acquisitions involving sales and settlement price, replacement cost and value in use. **I agree** i.e. the remeasured amount for assets converted to cash

The economic resource measurement relates to the preparation of the financial statement when (1) the item meets the definition of an element (2) an item is measurable reliably or ***utilizing a reliable metric*** **I agree**

Near term financial resources have a distinct symmetry:
o assets are resources received by the end of the period and in cash or near term
o the liability is paid at the end of the period pp. 6 **I agree**

Contingent liabilities may accrue from derivative transactions engaged in by different governmental entities.

The inflow of resources involves property taxes collected for the period

which can be collected in the near term i.e. can be converted to cash or are repayments from lending activities due in the period or are proceeds from borrowing long term debt and revenue anticipation notes for the period

I agree

Property tax collection is less predictable in an environment of higher mortgage defaults and personal bankruptcies.

Outflows of resources and inflows are related to changes in the fair value of recognition of assets/liabilities when the items are related to inflows of resources in the future. i.e. interest rate swaps meeting the hedging criteria reported at fair value

I agree

Similarly, deferred outflows of resources or inflows may be associated with a series of future interest payments or hedged amounts. pp. 9
Initial amounts are more appropriate for assets used in providing services.

I agree

An assessment must be made of the reliability of remeasured amounts. This process may be complex with regard to assets/liabilities in 'active markets' . # 28/ pp. 16

I agree

Reliability is a concept which is difficult to determine in a world market in a state of flux in the short to intermediate term. The VIX index , weighted averages, moving averages and the use of vendor software are the current tools which assist management in determining market fluctuations and the potential impact on securities and other instrument valuations.

Some assets or liabilities require experts to opine on values. #31/ p. 17

I agree

Transactions; such as derivatives require legal experts and experts in other areas of science or business to formulate contracts which fairly set forth the rights, duties, liabilities and recourse of the parties under foreseeable market conditions which typify the transaction entered into by the parties and counterparties.

Derivative transactions are beginning to be more prominent in government accounting. GASB has indicated that:

“The fair value of all derivatives be reported as assets or liabilities in the financial statements” and that any “additional information about derivatives be disclosed in the notes to the financial statements, including identification of the risks to which hedging derivatives expose a government, the fair values and notional amounts of derivative instruments and contingent liabilities contained within derivatives.”

Background:

The OCC (Office of Comptroller of the Currency) issued a report on the 4th quarter of 2003 bank derivatives. The OCC quarterly report of bank derivatives and trading revenues is based upon call report data by the insured commercial banks in the USA. The notional amounts equal the nominal or face amount used to compute payments made on swaps and other risk management products. This amount doesn't change hands. Thus, the term nominal is used.

The 4th Quarter of 2003 OCC report documents 7 banks with the most derivatives which comprise over 96% of the total derivatives in 573 commercial banks with derivatives. These derivatives are in futures,

swaps, options and credit derivatives. Source Graph 4; P. 9

The derivatives (notionals) by the type of user grew from \$8 trillion dollars in 1990 to over \$70 trillion dollars by 2003. (Mostly dealer notionals)
Source: P. 6 of 27

The change in the notional volume reflects business activity and not risks per se. " 7 commercial banks account for 96% of the total notional amount of derivatives in the commercial banking system with 99% held by the top 25 banks". Table 3,5 and Graph 4

Risks are a function of the following items:
(Source: OCC 4th Quarter Report '03)

- o counterparty exchange of nominal principal
- o volatility of interest rates and currencies used to determine the contract payments
- o the maturity and liquidity of contracts
- o creditworthiness of counterparties in the transaction

The degree of risk is a function of:

- o aggregate trading positions
- o asset and liability structures
- o data describing fair values and credit risk exposure is more useful for point in time risk exposure
- o data on trading revenues and contractual maturities

Table 4 describes counterparty risk exposure. Counterparty risk exposure ignores collateral from clients to secure exposures from derivative contracts. A more meaningful analysis is to reduce the current credit exposure by liquid collateral held against exposures. This reduction is dependent upon the timeliness of a reduction in the liquid collateral. In addition, liquid collateral may change value in an environment where the VIX index is rising.

Contract banks have agreements customarily drawn by the legal counsel and experts in derivatives. The agreements permit the bank to close out the transaction if the counterparty cannot post collateral according to the contract terms.

The limit of losses may be dependent upon the timeliness of the bank close out of the transaction.

This gaping hole begs for a superior derivative strategy program of implementation on the part of all parties to these transactions. The process may be helped by more definitive guidance from the Uniform Commercial Code on derivative products since the UCC is an evolving legal document.

In addition, the Comptroller of the Currency may coordinate its findings on derivatives with the

Securities and Exchange Commission , as well as the National Association of Securities Dealers.

At some point, a federal authority may be given some discretionary/resolution authority to act or enhance rule structures under emergency conditions.

A major theme of risk exposure involves drawing air tight agreements which cover contingencies on derivative contracts. Generally, the legal counsel and derivative experts construct these agreements. Since all parties to the transaction have legal representation and experts, Courts may be more disposed to "Let the buyer beware" since the buyers and sellers have teams of hired experts in the art of derivatives.

I concur with the GASB movement in the direction of fair reporting of derivative transactions. Concurrent with this evolving reporting requirement is the need to define a derivative legally in the Uniform Commercial Code as to the rights, duties, obligations, liabilities and recourse of the parties and counterparties to the transaction. This basic legal definition would assist preparers of financial statements, experts in contract formulation and the various Courts charged with interpreting the law in the various disputes arising from the formulation and implementation of derivative contracts between the various parties and counterparties.

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The United States District Court, Middle District Tenn. made some very important observations on strengthening corporate governance. These recommendations have very important ramifications **for all corporate and even governmental entities.**

The details of the case and the recommendations are listed below:

Columbia/HCA Derivative Litigation (McCall v. Scott)
Court: United States District Court, Middle District of Tennessee
Case Number: 97-cv-838
Judge: Hon. Thomas A. Higgins
Case Contacts: Max W. Berger, Avi Josefson

This is a derivative action filed on behalf of Columbia/HCA Healthcare Corporation (now known as HCA Inc.)

against certain former senior executives and current and former members of HCA's Board of Directors seeking to

cause HCA to reform its corporate governance processes, and to hold the defendants responsible for directing

or enabling HCA to commit the largest healthcare fraud in U.S. history. The firm represents the

New York State Common Retirement Fund, the California Public Employees'

Retirement System ("CalPERS"), the New York City Pension Funds, the New York State Teachers' Retirement System and

the Los Angeles County Employees' Retirement Association ("LACERA").

Although the district court initially dismissed the action, the United States Court of Appeals for the Sixth Circuit reversed that

dismissal and upheld the complaint in substantial part, and remanded the case back to the district court.

On February 4, 2003, New York State Comptroller , the sole trustee of the New York State Common Retirement Fund, announced that the parties had agreed in principle to settle the action, subject to approval of the district court. As part of the settlement, HCA will adopt a **corporate governance plan** that goes well beyond the requirements both of the Sarbanes-Oxley Act and of the rules that the New York Stock Exchange has proposed to the SEC, and also enhances the corporate governance structure presently in place at HCA. HCA also will receive \$14 million. Under the sweeping governance plan, the HCA Board of Directors will be substantially independent, and will have increased power and responsibility to oversee fair and accurate financial reporting.

Some of the more **significant provisions** are:

- o **Two-thirds of the Board of Directors must be independent.** In addition to not having been employed by the Corporation in the last five years, an independent director must not have performed any significant consulting work for HCA within the last five years. Independent Directors may retain legal counsel and other consultants to advise them. The entire Board, or appropriate committees consisting entirely of independent directors, will monitor internal control and corporate compliance.
- o **HCA's Audit Committee will be comprised solely of independent directors** and have at least two members with accounting or financial experience. The Audit Committee must also meet with management and the external auditors prior to the filing of each annual report and quarterly report.
- o **The external auditing firm must be rotated every seven years** unless the Audit Committee affirmatively determines that rotation is not in the Company's best interests. This determination must be made every three years.
- o **Candidates for election or re-election to the Company's Board are restricted in the number of other company boards on which may serve.**
- o **Specific internal control and corporate compliance responsibilities**, including specific procedures in the event the Board becomes aware of any material departure from corporate compliance programs or internal control programs, or of material violations of established corporate policies or legal and regulatory requirements.
- o **Shareholders must be given the opportunity to vote on the issuance of any equity compensation to any executive who, at the time of such issuance, is one of the Company's five highest paid executives**, unless the equity compensation is issued pursuant to a plan previously approved by the Company's shareholders.
- o **Heightened Core Competencies, which must be considered in connection with election and the re-election of directors.**

There is no waiting period for the implementation of the enhanced provisions; they become effective immediately upon the Effective Date of the settlement.

In granting final approval of the settlement on June 3, 2003, the Honorable Senior Judge Thomas A. Higgins of the District Court said that the settlement "confers an exceptional benefit upon the company and the shareholders by way of the corporate governance plan."