The Financial Accounting Standards Board of Derivatives Activity and Disclosure

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I would like to open my remarks with the observation that there is nothing wrong with our project on accounting for derivatives and hedging activities that a little controversy would not solve. The FASB has been working diligently on a hedge accounting model for more than four years. The Board undertook this project mainly because the accounting for derivatives and hedging activities is incomplete and inconsistent and consequently, the effects of derivatives are not transparent in the basic financial statements. Only certain types of derivatives and hedging activities are specifically addressed in existing standards for financial reporting. Consequently, companies have been forced to adapt other accounting standards to develop their own practices and, as a result, reporting of derivatives and hedging activities can easily confuse or mislead investors, creditors, and other users of financial statements.

An example of this confusion is that realized gains and losses on derivatives used to hedge risks are often reported as assets and liabilities rather than as income or expense in an income statement. In addition, many derivatives are reported at their historical cost, which is either a very low number or zero, and some others, such as swaps and forwards, are not reported at all. Also, there is a leverage factor—the amount that an entity stands to gain or lose on a derivative transaction is generally substantially more than its investment. Investors and creditors simply cannot determine from a company's basic financial statements the magnitude of gains or losses that might be realized when those derivatives are settled. Several times in the last few years, investors and creditors have been surprised by large unexpected losses on derivatives by companies that reported them at historical cost or did not report them at all.

Initially this project was designed to broadly address hedge accounting. Focus changed to accounting for derivatives. This change occurred primarily because most hedging is done with derivatives, and hedge accounting is thought of as special—that is, it is based on exception. But in order to have an exception, you need to know what...
the normal accounting is. In this case, as I just noted, we do not know what is normal.

Demand for special accounting for hedges of the exposure to price changes of existing assets and liabilities arises, on a basic level, because of accounting anomalies—that is, differences in the way hedged items and hedging instruments are recognized and measured. Recognition anomalies arise because some assets and liabilities are recognized in the statement of financial position, that is standard setting parlance for the balance sheet, while others, such as many firm commitments, are not. Measurement anomalies arise because existing accounting standards use different attributes for different assets and liabilities.

Some assets and liabilities are measured based on historical cost, others are measured based on current prices, and still others are measured based on a combination of historical and current prices or lower-of-cost-or-market value. In setting accounting standards, accounting recognition and measurement decisions generally have been made independently for each kind of asset or liability without considering relationships with other assets or liabilities. Hedge accounting for assets and liabilities arose, in the past, as a means of compensating for situations where anomalies between the way a hedged item and hedging instrument are accounted for result in recognizing offsetting gains and losses in earnings in different periods.

It has taken the Board a long time to resolve the special accounting because of the extreme complexity of the issues and disagreement among the Board members over the answers to some of the questions involved. Our difficulties have been complicated even more because of differing viewpoints of our constituents of what constitutes risk and how they manage it.

I. CFO’s View vs. Treasurer’s View

It is awfully hard to craft an accounting standard that will accommodate all of the differing objectives of risk management at the same time. But to refresh your memories, let me review some of the complexities involved. First of all, what is a hedge? Should only transactions that lock in a price qualify, or should transactions that alter a company’s risk profile to a desired level qualify? The real question here is, must a hedge reduce risk? Most people on the street, but not most of our constituents, would say, absolutely—that is what hedges are for.

So, how do you define risk and risk reduction—is it reduced exposure to loss or does simply lowering the dispersion of possible outcomes constitute reduction of risk? Let me give you an example of what I am talking about. If you have natural exposure of being long 100,000, is it less “taking of a position” (some people call that specu-
lating) if you hedge 50,000 of it by entering into an offsetting short derivative than if you enter into a short derivative contract for 150,000, thereby ending up being short 50,000? In either case you now have a 50,000 position and that is less than the initial 100,000 position, but many would argue that in the latter case, as soon as you cross the line between being long and short, you took on risk.

The Board has been unable to agree on this fundamental issue—that is, what is risk and what constitutes risk reduction? But no matter what your conclusion is as to what constitutes risk reduction, you then have to make a judgment as to whether it is sufficient to reduce risk on a transaction-by-transaction basis or whether the transaction must reduce risk to the enterprise as a whole?

At the beginning of this project, most Board members believed there should be some sort of test to ensure that the enterprise as a whole has reduced risk through the hedging transaction and, in fact, that is what our existing hedge accounting standard, Statement 80, requires. But people want to hedge risks of changing cash flows as well as risks of changes in market values, and the Board has also concluded that it is impossible to design an enterprise risk test in a model that accommodates hedges of both market value risk and cash flow risk because the strategies to hedge them are incompatible. For example, fixed rate asset—exposed to risk of changes in value—concerned rates will rise; variable rate asset—exposed to cash flow risks—concerned rates will fall. You cannot design a test that would apply to the whole enterprise and accommodate both of these kinds of risk.

Consider another example: assume a company operates an airline; it keeps three month supply of jet fuel for emergencies; and its risk management plan looks out six months—tries to manage six months of price exposure. If the company purchases fuel six months forward, has it reduced risk? Since it already has risk of loss in inventory, the forward purchase actually increases risk of loss if the price of jet fuel goes down. But the company could legitimately argue it has reduced exposure to increases in fuel prices for the six month period. Again, we do not think you can devise an enterprise risk reduction test to cover both of these circumstances. And because we were not able to do so, in the Exposure Draft (the "ED") we settled on an approach that permits special accounting as long as it appears that risk is being reduced on a transaction-by-transaction basis—even if risk of the total enterprise actually increases.

In response to constituent concerns that they wouldn't be able to manage risk in the way they would like to—that is, select the level of risk they want and alter it depending on their views of the market (some might call this speculation, by the way)—the Board made a number of changes to the ED. I would argue (and some of my fellow Board members may disagree) that in the final statement, at least as it
stands now, we have abandoned any notion that risk must be reduced at all in order for a derivative to receive special accounting.

Issues involving risk reduction were not the only issues that would add complexity to a new standard. There are also other important questions such as: Should there be tests of the effectiveness of a hedge, with the ineffective portion going to earnings? Or is an undefined correlation, like we currently have in our Statement 80, sufficient? The Board considered defining the manner in which effectiveness should be determined—actually we worked on it for a long time. But, again, in response to constituents' concerns about limiting their ability to employ risk management strategies, in the end we left the method of assessing the effectiveness of a hedge up to management, with the stipulation that the method had to comport with the overall risk management strategy of the entity.

The question that has generated much of the controversy in the current proposal is whether it is important that deferred gains and losses meet our existing definitions of assets and liabilities. A deferred loss is not an asset—there are no future benefits associated with losses. Yet much of the current dissatisfaction of the banking community with the proposal is that deferred losses and gains on derivative transactions would not be allowed to be shown as assets and liabilities. Instead, they are reflected in other comprehensive income; that is, they affect equity and consequently, reported equity becomes volatile. But the Board has been resolute that only items that meet our definitions of assets and liabilities should be reflected in the balance sheet—in fact, that is one of the fundamental cornerstones of the current document.

To get to where we are today, we have been down several different avenues. Initially, some of the Board members were unwilling to make certain compromises in their beliefs in order to get to an answer. Essentially we were looking for the Holy Grail—the perfect solution and, frankly, there just is not one until we can measure all financial instruments at fair value. Most of the Board believes that all financial instruments should be reported at fair value in the balance sheet, with changes in value being reported in earnings—this vision is articulated in the ED. However, it is difficult to determine the fair values of many financial instruments, liabilities in particular, and there are other conceptual issues that need to be resolved before that vision can become a reality. Until we resolve some of these issues, we will have a mixed attribute accounting model where some financial instruments are carried at fair value, while others are at historical cost.

Anyway, during our deliberations, constituents and others, particularly the SEC, made it clear that they were losing patience and urged the Board to get something done on derivatives—even if it is only a temporary solution. I think it is safe to say that all of the Board members believe that the most important goal of this project is to get visi-
bility over derivative instruments—get them on the balance sheet. Thus, that tenet became the guiding light for the project. As I mentioned, currently, many risks are off the balance sheet, but there is also inadequate disclosure. I must commend banks, as a group, for substantially improving disclosures the past couple of years.

II. P&G, Gibson Greetings, Money Market Funds

Investors and creditors uniformly mystified and frustrated about effects of derivatives. Transparency of a company's derivative positions will certainly help in that regard. As an aside, I might note that getting more visibility over derivatives was also one of the principal goals of the SEC.

A year ago last June, we issued an Exposure Draft that was based on the following four cornerstones: 1) Derivatives are assets and liabilities and accordingly should be reflected in the balance sheet; 2) But only true assets and liabilities should be reported as such—that is, realized losses and gains are not assets or liabilities, and should not be reported as if they were; 3) Fair value is the only relevant measurement attribute for derivatives; and 4) Hedge accounting should be permitted only for those transactions that meet specified criteria.

In response to comment letters and testimony at the public hearings we held, we have made a number of changes to the ED. But I would like to emphasize that both the ED and the final statement that we are currently working toward are compromises. As such, they are obviously imperfect and not everybody is going to be satisfied. But, as I said, a perfect solution does not exist.

But my current prediction—by the way my predictions on these kind of matters are generally wrong—would be that, assuming we issue a final statement that is substantially similar to what I am about to outline, that thereafter, the ability to defer gains and losses on derivatives will diminish rather than increase. This is because, as the Board continues to work on financial instruments in general, and on measuring and reporting the fair values of liabilities in particular, many of the anomalies that necessitate special accounting for hedges today will be eliminated, thereby co-opting the need for special accounting. Consequently, I do predict, and in fact the final Statement will say as much, that many of the provisions in the standard will be modified later.

Anyway, let me summarize where we are now. To begin with, we are on track to issue a final Statement by year-end in order for entities to have a full year before the standard is effective. As I said earlier, there is unanimity among the Board members and the SEC, at least, that all derivatives, including swaps and forwards, should be carried as assets and liabilities in the balance sheet and marked to market—in other words, carried at their fair value. That is the touchstone of all
the alternatives that we have considered and was incorporated in the ED, as well as anchoring the current direction.

For fair value hedges—that is, hedges of an existing asset or liability designed to protect the value of that item—the ED called for the gains and losses on those items to be recognized in income. Concurrently, changes in the fair value of the entire hedged asset or liability would be accelerated and also included in income.

Most of the comment letters we received argued that often only identified risks within an asset or liability are hedged, and that by accelerating into income all of the change in the fair value of the hedged item there would be a mismatch in earnings. These letters argued that for derivatives designated as hedges there should be full deferral of gains and losses in the basis of the hedged item—we call this basis adjustment accounting. The effect of allowing basis adjustment accounting is that even if a hedge is ineffective in achieving its objective, there is no effect on net income—most Board members think that is inappropriate. Furthermore, when forecasted transactions have been hedged, at the time the transaction occurs it is always recorded at an amount that is different from its fair value—many Board members find this unacceptable.

Although basis adjustments certainly was not a new concept and the Board had already spent a great deal of time on it before we issued the ED, we responded to the comments by reopening our deliberations to consider in what circumstances, if any, basis adjustments and deferral of realized gains and losses might be permitted. Basis adjustments is a particularly difficult issue. Most Board members do not think they should be permitted at all, but many of our constituents contend that they must be allowed to follow the "economics" that companies are trying to achieve. With respect to the economics, I guess the principal question that needs to be answered is whether we are supposed to be trying to account for the economics that actually occurred or for the economics that management wanted to achieve by entering into the derivative contracts. Many of our constituents answer the latter.

Let me illustrate some of the controversy over basis adjustments by asking a few questions: You bought a German Treasury note and you paid $800,000 cash for it and delivered something else, which was readily measurable and realizable, worth $200,000. Most of us would say the note should be recorded at $1 million—that is the value you gave up. Why then, if the something else given is an option to buy the note, which is worth $200,000, would the note be recorded at the sum of the cost of that option and $800,000 of cash? Assume you like that answer; would the basis of the note be different if you sell the option on the note for $200,000, recording a substantial gain on it, immediately before or concurrent to paying $1 million in cash for the note? Does it make a difference if the option is on $1 million worth of
It might be easy to answer each of these questions until you have to rationalize your answers to some underlying consistent concept or principle. Up to now, we have not found a way to do this in a way that satisfies people. But these questions illustrate some of the reasons the Board rejected basis adjustment accounting. To be candid, the modifications that we made to the Exposure Draft move the accounting, for at least the income statement effects, very close to that which would result if we allowed basis adjustments.

The Board was sympathetic that perhaps by trying to eliminate anomalies, our approach to fair value hedges in the Exposure Draft could, in fact, create more distortion in certain instances. In order to address that concern, we switched to a separation-by-risk approach which would enable an entity to identify the specific risk they were hedging and accelerate only the gains and losses associated with that risk into income.

This change in approach will more readily enable people to design hedges that will offset those changes in the hedged item that they want to hedge, so that the impact on net income will be relatively neutral if the hedge achieves its objective. For hedges that are designed to reduce the variability of cash flows—including those associated with forecasted transactions—the net gain or loss on the hedging derivative is accumulated in other comprehensive income—in other words, taken directly to equity. Those gains and losses continue to be carried in OCI until the corresponding losses and gains on the hedged item are recognized, at which time they are also recognized in earnings.

This is a fundamentally different approach than that taken in the Exposure Draft which required that upon the occurrence of the transaction the gains and losses would be recognized in income. So, under the Exposure Draft, if you wanted to lock in the interest rate on a future borrowing, depending on how you structured it, the gain or loss on the derivative would have been reflected in income at the time of the borrowing and the actual interest incurred would be charged to expense in subsequent periods. Under the new approach, interest would be adjusted each period to reflect the rate that was locked in by the hedge. Thus, most of the time, if there is no basis risk in the hedge, entities will get the “matching” of gains and losses that they get under current practice.

Under the separation-by-risk approach, we considered several methods of assessing the effectiveness of a hedge with the idea that the portion of the hedge that was ineffective would be taken to earnings currently. We made several general decisions on how to assess effectiveness, but several groups pointed out situations where that general approach would produce an undesirable result. This is really a function, again, of the diversity of risk management practices that I alluded to earlier.
Our initial approach to address these situations was to create exceptions or modify the general principle to accommodate certain transactions that would otherwise have not been deemed effective. By the time we had done that several times, the standard had become so complex it would have been very difficult to apply. In the end we adopted an approach that would allow management to design an effectiveness test that was compatible with its intended risk management objective. However, under the proposed standard, the ineffective portion of all hedges would be recorded through earnings.

The final statement will also specify certain conditions that would have to be met in order to qualify for hedge accounting treatment such as: 1) Hedges would have to be consistent with an articulated risk management policy; 2) Management would have to designate the hedge in advance and document the hedging relationship; and 3) The statement would have to describe the purpose and objective of the hedge, and how its effectiveness will be assessed. Derivatives would also have to be specifically identified as relating to a single instrument or portfolio of similar instruments that is expected to have offsetting economic effects to that of the derivative.

**Conclusion**

Those are the fundamental provisions of the proposal we have on the table. But we also made some changes to the qualifying criteria for derivatives so that it is clear that options would qualify for hedge accounting in most circumstances. For options used as *fair value hedges*, the changes in value of the hedged item would only be recognized in earnings during those periods that the option has intrinsic value—that is, when it is in the money. Likewise, for options hedging *cash flows*, the changes in fair value of the derivative would be reported in OCI only when the option has an intrinsic value. When it is out of the money, changes would be reported in earnings.

We also made some changes that would accommodate rollover hedging strategies and a practice called tailing when futures are used to hedge a long-term exposure. Additionally, clarifications were made that qualified delta-neutral hedging strategies for special accounting. That summarizes where we are at this point. We will go ahead with a final statement that will be substantially the same as the ideas I have outlined today, and we hope it will be issued by year-end.