

What's Normal In Derivatives Accounting?

As broad as the field of derivative accounting is, much of the concern over the rules is that they are too broad. And efforts to clarify the standards have created issues of their own.

During the formative stages of Financial Accounting Standard No. 133 — the rule pertaining to derivative instruments and hedging transactions — many observers voiced concerns that a host of contractual arrangements, including many purchases and sales agreements, satisfied the definition of a derivative and had to be accounted for as such.

These concerns were mollified to a large degree, however, when the standard was amended (by FAS 138), and

The “normal purchase and sales” exemption in FAS 133 allows companies to ignore the fact that their purchase and sales agreements satisfy the definition of a derivative, as long as certain conditions are met.

the “normal purchase and sales” exception was clarified. For those qualifying under this exception, FAS 133 accounting rules are not applied even if their contracts have features of derivatives.

Two problems have emerged: (1) The exemption is narrowly defined,

such that many purchases and sales must still be accounted for as derivative contracts, and, in any case, the effort to assess whether FAS 133 applies has not been obviated; and (2) applying the normal purchase-and-sales exemption may mask a company's risks and opportunities.

In the pre-FAS 133 world, derivatives were reasonably well understood by financial professionals. Used either for hedging or trading purposes, derivative instruments simply allowed counterparties to realize the performance of some underlying price (interest rate or currency exchange rate), without having to hold a position in the underlying instrument, per se. FAS 133 introduced somewhat of a

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new twist by formally defining a derivative in a brand new way, requiring that three specific conditions be satisfied:

1. The instrument in question has to have at least one underlying reference (such as a price, interest rate, or currency exchange rate), at least one notional amount (such as a size variable), and/or a payment provision, such that prospective settlement amounts can be readily determined.
2. The instrument in question is initially traded at (a) a price equal to zero or (b) a value that is smaller than

option-based" contracts. The revised condition would require that, to be a derivative, the initial net investment must be (a) equal to the fair value of the option component if an option-based contract, or (b) less than 5 percent of the prepaid amount of a non-option based contract.

3. The instrument in question requires or allows net settlement — a feature that permits at least one of the parties to cash out of the contract and be relieved of all rights and obligations. Alternatively, if physical delivery is required, the delivered instru-

readily convertible to cash and thus satisfy this third point.

To the relief of many potentially affected companies, the normal purchase and sales exemption (Paragraph 10b of FAS 133) saved the day. That is, the FASB now allows companies to ignore the fact that their purchase and sales agreements satisfy the definition of a derivative as long as (a) it is probable that the company will, in fact, take part in a physical transfer of the underlying property; (b) the amounts specified in the contract reflect quantities that are expected to be used or sold over a "reasonable period in the normal course of business"; and (c) the designation of a normal purchase or sale is documented.

If these conditions are satisfied, even if a net settlement provision is a part of the contractual documentation, companies would continue to account for these purchases and sales as they always had, prior to FAS 133. (Power purchase and sales agreements have some special considerations, as noted in the FASB's May exposure draft, paragraph 58b.)

A Best Practices Primer

1. Understand your contractual exposures. All sales and purchase contracts bear an inherent exposure. Companies should determine the expected value of these contracts and the potential best-case/worst-case scenarios.
2. Understand anticipated exposures. Many purchases and sales occur in spot markets, where there is no "pre-transfer" paper trail. Such trades nonetheless involve risks and opportunities that should be recognized.
3. Assess the exposures inherent in the contractual purchase and sales agreements and in the non-contractual intentions — both individually and on a consolidated basis.
4. Determine which risks (and opportunities) the company wants to maintain, versus risks the company would prefer to lay off.
5. Investigate whether undesirable risks can be offset or shared with new or existing counterparties.
6. Investigate whether derivative instruments may be viable risk-shifting mechanisms.
7. Compare alternative risk mitigating strategies; select and implement the most attractive alternative.
8. Review and reassess exposures on an ongoing basis and modify business practices and derivative positions as appropriate.

Problem 1: Typical and reasonable might not be "normal"

As significant as the normal purchase and sales exemption is, not all purchase and sales agreements are necessarily covered. With the sole exception of some contracts relating to electricity, contracts that have an uncertain deliverable quantity cannot be considered "normal." Aside from the basic text in FAS 133, the FASB also has promulgated a diverse set of clarifications as "Derivative Implementation Guidance," and according to DIG Issue C10, volumetric optionality violates the requirement that delivery must be probable. Thus, a traditional purchased call (put) option contract may not be designated as a normal purchase (sale).

This restriction also applies to forward sales or purchase contracts that require a minimum quantity to be exchanged, with an allowance for one of the parties to buy or sell additional quantities at some pre-determined price. Critically, a contract of this type

the initial net investment required for other contracts that could be expected to generate a similar market response. (Think about an option premium, which is always smaller than the price of the instrument underlying the option.)

At the time of publication, the Financial Accounting Standards Board (FASB) is in the midst of the comment period for an exposure draft, initially released on May 1, 2002, which suggests different language relating to the initial net investment condition. The new language, if adopted, would distinguish between "option-based" contracts and "non-

ment can be readily converted to cash.

In thinking about traditional purchase and sales contracts, the first two points apply, virtually universally. Thus, whether these contracts would be considered to be derivatives under FAS 133 ultimately falls to the third point; and this condition casts a wide net. Many companies explicitly require or permit net settlement in their purchase and sales contracts as a matter of course, expecting that these terms would be used infrequently, but serving as a protective device in unusual circumstances. Other companies simply buy or sell basic commodities, which, by their nature, are

would have to be treated as a derivative in its entirety. It cannot be bifurcated and considered to be part-normal and part-derivative.

Problem 2: Out-of-sight, out-of-mind

By qualifying for the normal purchase and sales exemption, these contractual arrangements are not recorded as assets or liabilities. Thus, their associated exposures are not transparent, and this lack of transparency may affect the way managers handle the associated contract exposure.

Consider two cases: (1) On Jan. 2, 20XX, AAA Widget Co. engages in a forward sale to a customer, committing to sell 1,000 units at a fixed price of \$10 per unit, with a Dec. 15, 20XX settlement date. Assuming the delivery is probable and the trade is documented as a normal sale, this trade will not be reflected in the financial statements.

In contrast, (2) BBB Widget Co. chooses to hedge a forward sale with a widget futures contract. Ultimately, the widgets would be sold in the spot market in December, when the widget futures contract would be liquidated. Gains on the futures contract would offset a lower spot price for widgets; or, alternatively, losses on the futures would offset a higher price of widgets.

Ordinarily, one would expect the futures contract, when used in this way, to be designated as a cash flow hedge for the forecasted sale in December. In that case, futures gains or losses throughout the January-December period would be recorded in other comprehensive income (OCI) and then reclassified into earnings when the sale is recorded in December.

Assuming the hedge was perfectly effective, the two different companies would bear precisely the same market risk, and both would record the same revenues, in the same period. Still, it's reasonable to expect that the second seller perceives himself as a hedger, while the first probably does not.

Thus, the second hedger might be expected to adjust the degree of hedge in response to changing market conditions. The first manufacturer, on the

other hand, would be more likely to maintain the unaltered static forward sale contract, irrespective of the changing economic landscape.

The better way

Does it make sense for these two companies — each having an identical economic exposure to the other — to manage their risks so differently? Or, perhaps the better question is, "Which approach is better?"

The static approach is certainly simpler, and it also yields a certain, pre-determined result — except in the case of customer default. On the other hand, it completely disregards any chance for opportunistic gains. Is it reasonable to allow a manager charged with a fiduciary responsibility to categorically ignore market information and maintain an economic exposure beyond the point when that position is justified?

While the static approach of simply holding the unaltered forward contract may turn out to be more profitable than a dynamic risk management alternative in any single situation, in the long run, the firm that reacts to changing risks and opportunities in a disciplined and business-like manner should have a considerable advantage over a competitor who categorically ignores available information.

Purchase and sales contracts are, in fact, forward contracts. Whether these contracts are recognized assets or liabilities (as they would be if they are determined to be derivatives) or not (as in the case of normal purchases and sales), they have economic values that vary over time. Systematically ignoring this reality seems hard to justify.

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