

Implementing the Derivatives Accounting Standard

By

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Although the ink is dry on the new Financial Accounting Standard 133, it ain't over yet. We've just moved to a new phase. Now that the rules have been written, the Board is concentrating on implementation issues. Assisting in this effort is a Board-appointed Derivatives Implementation Group (DIG), which has been assembled to advise the Board on a host of concerns that have surfaced since the release of the document. The deliberations of the DIG are open to the public, and their recommendations are posted on the FASB's web site (<http://www.rutgers.edu/Accounting/raw/fasb/digsum.html>). Importantly, the DIG's recommendations should be viewed as tentative until the Board makes a final determination.

In my own judgement, the most controversial and contentious discussions will deal with the concept of hedge effectiveness. To start, the FASB requires that special hedge accounting treatment will only be permitted if hedges can be expected to be "highly effective." By imposing this pre-condition, the Board hopes to insure that hedge accounting will be applied *only* to hedges that work. Put another way, the Board recognizes the validity of the marrying the hedge results to those of the underlying

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exposure, but it wants this special treatment to be well deserved. The Board only wants to sanction the marriage if there's been a long engagement and the parents approve; and for sure, the wedding is off if the lovers barely know each other.

Despite the intuitive appeal of the Board's orientation, it remains to be seen how practice will evolve to meet the "highly effective" criterion. Moreover, even if management is able to validate that the hedge will be highly effective and hedge accounting is thereby justified, the "marriage" may still have some rocky moments, as some of the subsequent accounting requirements have disquieting consequences.

First consider fair value hedges, where the gain or loss on the derivative flows through current income, as does the change in value of the underlying asset, liability, or firm commitment due to the risk in question. Given this design, the Board reasoned that any ineffectiveness of the hedge would be transparent, equal to the difference between the two contributions to earnings. In a perfect hedge, the income effects should be equal and opposite. Unfortunately, while true for some derivatives, this outcome will generally *not* be true for others. For example, if a long option position served as the hedge for an asset, liability, or a firm commitment, the change in the value of the option will *consistently* be smaller than the change in the value of the hedged item. As a result, the exposure's contribution to earnings will dominate.

FASB staff has indicated that this practice will likely be re-considered, possibly allowing for the exposure to affect income *only* when the associated option is in-the-money. This

step would eliminate the most egregious imbalances, but it wouldn't really solve the problem entirely. Put more technically, because the delta of an option is always less than unity for one-to-one hedges, the change in the option's value *always* will be some fraction of the change of the exposure being hedged. Those who are concerned about the prospect that hedging may introduce some degree of income volatility will undoubtedly shy away from using options for fair value hedges – unless the Board makes a more dramatic modification.

One possible solution would be to limit the exposure's contribution to income to no more than the magnitude of the gain or loss generated by the derivative. This adjustment is less than ideal in that it would contribute to situations where balance sheet items would be valued neither at cost nor market; so it becomes a judgement call as to whether this cure would be better or worse than the disease. Unfortunately, under the constraints of the document, no universally acceptable solution appears to be available.

Another perverse outcome for fair value hedges occurs if and when hedges turn out to be ineffective – contrary to the initial expectation. When this result occurs, hedge accounting would no longer be justified *prospectively*. Suppose, for example, the expected offset does not occur and, instead, losses are generated on both the exposure and the hedge. FAS 133 requires that beginning from the time that the effectiveness test fails, only the derivative's effects flow to earnings. Thus from that point, the losses on the exposure will no longer be realized in current earnings. The perverse aspect of this ruling is that *not* including the exposure's effects in earnings makes the firm's financial

statement look *more* attractive, rather than less. Continuing with the hedge treatment, on the other hand, would reflect a more conservative representation of the firm's financial condition.

The issue of effectiveness may be even more problematic when we turn to cashflow hedges. Under these rules, different treatment is stipulated for "effective" versus "ineffective" derivative results. Again, difficulty arises in making the assessment as to how to measure effectiveness.

The problem is particularly severe in connection with options. Consider, for example, the purchase of a call on British Pounds to hedge the risk associated with a prospective purchase of some imported machinery from the UK. Assume the selected option has a strike price of \$1.50/BP and an expiration timed to coincide with a specified prospective trade date. If the spot price of Pounds is less than \$1.50 on the prospective trade date (at the option expiration) the "all-in" price of Pounds will be the spot price at the time of the currency exchange, plus the original option premium. Otherwise, if the spot price is at or above \$1.50, the effective price of Pounds will be \$1.50 plus the option premium. That is, the option will be exercised.

It should be clear that this hedge will work – i.e., the *ex ante* expectations will be realized -- barring default on the part of the counterparty. Accepting this conclusion, one might expect that all of the gains or losses on the option would flow through comprehensive income. After all, the hedge will be *entirely* effective. At present, however, this outcome

is not assured. Instead, the prescribed treatment (as reflected in examples designed and disseminated by the FASB) divides the option premium between its time and intrinsic values. Only the changes in intrinsic value go to other comprehensive income; the change in the time value, on the other hand, is recorded in current income. Thus, as in the case of the option fair value hedges, some degree of income volatility may also result when options are used in cashflow hedges.

It deserves to be noted that the FASB has explicitly accepted the idea that effectiveness may be “assumed” in other contexts. It does so in two cases: (a) when forward contracts are used to offset changes in forward prices and (b) when interest rate swaps are tailored to match all the critical features of the underlying risk (i.e., notional amounts, tenors, timing of rate setting and payment dates, etc. – see paragraph 68 in the standard). In both of these situations, the FASB allows the assumption of perfect effectiveness and requires no further validation of the claim. An equivalent allowance for the case of similarly structured option hedges would go far toward easing the bias that currently seems to be in effect for these contracts.

It may be worth noting that, at least in theory, one could construct an effectiveness test for option hedges that would come close to allowing all the option’s change in value to be deferred, but implementing it requires fluency with differential calculus. Allowing a shortcut method for options would simply make this treatment accessible to a larger population of users.

The significance of the above discussion notwithstanding, the question of effectiveness is most critical to users of exchange-traded instruments. Because of their standardized nature of these contracts, at least some degree of ineffectiveness should be expected. The risk that this ineffectiveness could, at some point, force the abandonment of hedge accounting will no doubt induce some hedgers to rely exclusively on over-the-counter instruments. In turning away from exchange-traded products, however, users should be cognizant of the fact that they would be giving up the benefits of lesser credit risk and greater price transparency and ease of valuation.

Thus far, the Board has been notably silent about precisely how to measure effectiveness. Some observers champion this omission, viewing it as an opportunity for management to exercise its discretion to devise its own criteria. At the same time, a substantial portion of the accounting profession is craving guidance in this area, and it's likely that the DIG will make some recommendations. It is possible that some explicit, quantitative calculations may be suggested and ultimately approved by the Board -- but maybe not. The dilemma is this: Greater latitude on how to assess the prospective effectiveness of a hedge likely means that those who are more facile with derivatives will be able to articulate a methodology that validates hedge accounting, while those less experienced may have greater difficulty clearing this hurdle. Alternatively, a more explicit effectiveness test could end up being overly constraining, resulting in the forced termination of legitimate hedging strategies. Only time will tell.

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