FASB Won't Amend Options Treatment This Year

A near-the-deadline attempt by several corporations to have the Financial Accounting Standards Board amend the procedure for reporting the time value of currency options under FAS 133 has failed, at least in the short term.

"There is not likely to be any amendment having to do with that or anything on 133 this year," says Timothy Lucas, director of research at the Stamford, Conn.-based accounting policymaking body. "We couldn't possibly get that done by the end of the year."

Fannie Mae, Merck & Co., Eastman Chemical Co. and at least three other large companies formally requested an amendment earlier this year. Officials at several of the companies say they have stopped using foreign currency options because of the volatile effect on their bottom lines of reporting time value.

The companies want FASB to let them report the options' time value under OCI (other comprehensive income) rather than in their income statements. OCI, which shows changes in equity values of holdings, is not scrutinized by securities analysts because it does not affect earnings per share.

Theoretically, relief could come through an interpretation issued by the Derivatives Implementation Group (DIG), an advisory group that is working with FASB and industry on implementation of the policy. (As *T&RM* went to press, the group was expected to issue a letter freeing commercial paper-related swaps from some restrictive hedge definitions.) However, Lucas and Ira Kawaller, a Brooklyn, N.Y.-based consultant and a member of the DIG, say the options issue is not on the group's agenda.

The companies seeking relief alternatively want to report their option value changes on a prorated basis. "If they have $10 of time premium spread over 10 accounting periods, they would report only $1 per period," Kawaller explains. "Without the amendment, the amount recorded in income could be erratic. And for options that extend over long periods, the amounts could be erratic and large."

In a letter to FASB, Eastman Chemical Treasurer Al Wargo wrote that the company has long hedged its foreign sales through an option-based program that helps "diminish the period-to-period earnings volatility caused by changes in currency exchange rates…. [But] with the assistance of our outside consultant, we have estimated that [under FAS 133] quarterly earnings of $1/share could be impacted by as much as 100% in either direction as a direct result of recording the time value of options in earnings."

Companies can hedge their forex exposures by buying forward contracts, one of the few areas that is treated favorably under FAS 133. However, forwards, unlike options, lock buyers into purchasing the currencies—an outcome that some corporations want to avoid.

Preparing Investors for Bottom-Line Shock

Finance executives have been fretting that analysts and investors will overreact to the first set of negative FAS 133-related charges that show up in their quarterly earnings.

At a conference earlier this year, DuPont Treasurer Susan Stahlnecker mentioned the necessity of getting investor relations and public relations departments familiar with the accounting rule, its potentially volatile effect on earnings and its irrelevance to quarterly fundamentals.

In an early test of this effort, Microsoft CFO John Connors announced in late September that his company would take a $350 million "one-time" charge against earnings in its first fiscal quarter, which began last month. (Microsoft in mid-October actually reported a $375 million charge, which it emphasized was a "nonrecurring unrealized noncash charge." Sources say it reflected in large part some "embedded derivatives" from equity positions Microsoft has taken in other companies.)

Connors emphasized to analysts that the charge would reflect a one-time cumulative recognition of the fair market value of positions in its derivatives portfolio—but also said he could make no predictions on the effects of FAS 133 going forward into other quarters.

When Microsoft's earnings were reported, reactions to the FAS 133 effect were minimal. "Wall Street pretty much yawned and ignored it," says Brent Callinicos, treasurer of Microsoft.

Press reports mentioned the charge only in passing—or chose to ignore it. *The New York Times* glossed over FAS 133 with a report that the software giant reported "income before an accounting change of $2.58 billion, compared with $2.19 billion for the quarter last year."

The Wall Street Journal noted that Microsoft earned $2.2 billion in the quarter but added that profits would have been higher if not for a "$375 million charge to comply with new accounting rules governing derivatives." (On the other hand, the paper emphasized that the company's earnings were boosted $600 million, or three cents a share, by one-time investment portfolio gains. Neither report made reference to what Connors referred to in his regular post-mortem with analysts as "a $100 million negative impact" from translating euro revenues into dollars.)

Gillette's Hedges

Gillette has stopped using synthetic debt and basketing because of the FAS 133 effects it would have on the company's bottom line, Treasurer Gian Camuzzi said during a panel at *T&RM*'s 5th annual Alexander Hamilton Awards presentation in September.

"At times, we're forced to go and borrow in related currencies directly to avoid using derivatives," he said.

Over the next few months, we will update you on developments in corporations' handling of the adoption of the Financial Accounting Standards Board's policy on fair-market-value reporting of derivatives, or FAS 133. We welcome your comments, thoughts, queries and solutions. Please e-mail comments to jhorowitz@treasuryandrisk.com.