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By Andrew Osterland CFO Magazine Jul 01, 2001

## Life Under FAS 133

**For many companies, adjusting to the new rules for derivatives accounting has been an expensive--and arguably unnecessary--headache.**

The rules of accounting issued by the Financial Accounting Standards Board rarely generate enthusiasm in the corporate reporting community. But few have caused more outright resentment among business leaders than FAS 133, "Accounting for Derivative Instruments and Hedging Activities."

Nearly a decade in the making, the standard went into effect last June, but most companies--those with calendar year-ends--began reporting under the new rules in the first quarter of this year. They now have to carry the value of their derivative contracts on the balance sheet.

The goal of FAS 133 is to provide investors with more information on companies' risk management practices and the derivative transactions they enter into. But the reality, charge critics, has been an expensive, and arguably needless, exercise in frustration. A recent survey of finance executives at more than 200 companies by the Association for Financial Professionals (AFP) found that more than two-thirds of the respondents felt that FAS 133 imposed an excessive burden on reporting companies.

"This is standard overload," says General Electric Co. controller Philip Ameen of FAS 133's requirements. Ameen, a member of the Derivatives Implementation Group (DIG) for the past several years, says FASB "could have achieved 98 percent of [the goals of FAS 133] at about 10 percent of the cost."

### SEEDS OF DISCONTENT

Most of the cost, and virtually all of the frustration, have to do with the issue of hedge accounting. When FASB took up the derivatives accounting project in 1991, its initial proposal was simply to mark all derivatives to market on a quarterly basis and recognize the gains and losses on the contracts, realized or not, through the income statement. No mess, no fuss--except for a whole lot of potential earnings volatility that executives weren't prepared to accept. By way of compromise, the board agreed to preserve hedge accounting treatment, which allows a pairing of derivatives results with the gains or losses on the underlying items being hedged--thereby reducing earnings volatility.

This is not the same old hedge accounting, however. Pre-FAS 133, if companies qualified for hedge accounting, their hedges were assumed to be perfect--no valuation or testing required. Now, under FAS 133, risk managers seeking hedge accounting treatment have to thoroughly document each hedge from the outset and explain why they are undertaking the transaction. They have to mark their derivatives to market every quarter (no small feat for many instruments), then prove they are effectively hedging the underlying exposure. General Electric, for one, spent \$8 million over the past two years developing systems to perform these functions. That may be small potatoes for GE, but the effort required to build new systems or integrate FAS 133 software with existing systems has been a much bigger burden for most companies.

"The FASB has never endorsed hedge accounting," notes Ira Kawaller, a consultant who is also a sitting member of the DIG. With FAS 133, he says, the board "has effectively imposed a tax on companies to discourage the practice." And judging from the AFP survey, the tax is working. Twenty-five percent of respondents said they were marking a significant portion of their derivatives to market through earnings rather than go through the hassle of qualifying for hedge accounting--a trend that raises the issue of comparability for financial-statement users.

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The effort to comply with FAS 133 might seem less onerous if investors cared two wits about the new information. Large one-time FAS 133 transition charges by a few major companies may have grabbed some headlines, but the market has shown little concern.

Sears, Roebuck and Co., for example, will take a \$270 million charge to earnings this year for the termination of long-term interest rate swaps it entered into in 1997. Before FAS 133, the losses on the contracts would have been amortized to income over a 20-year period. The disclosure may give investors a clearer picture of the underlying performance of Sears's business, but in the context of its \$26 billion credit-card portfolio, it's not a major event. Likewise, Microsoft Corp.'s \$350 million charge last September isn't particularly significant, considering the company's \$23 billion in revenues and its large exposure to foreign-currency price movements.

Most finance executives believe that, for the most part, the market is looking through the new derivatives disclosures. Ed Bastian, controller of Delta Air Lines Inc., says that FAS 133 doesn't provide a more meaningful picture of Delta's performance. "If anything, it distracts investors from our true operating results," he says.

Brent Austin, CFO of El Paso Corp., can empathize. He's had his hands full explaining a whopping noncash charge of \$1.28 billion to other comprehensive income that El Paso booked last December. Reflecting the value of existing derivatives used to hedge the company's exposure to natural-gas prices, the charge represents the lost upside from soaring gas prices in the past two and a half years. Austin worries that the effects of the hedges on El Paso's financials "could be misleading" to less-sophisticated investors.

It raises the question: If investors are at best ignoring and at worst getting confused by the new derivatives information, why should companies jump through hoops to produce it? To become better hedgers, suggests DIG chairman Tim Lucas. "You manage what you measure. In some cases, FAS 133 may result in better hedging practices." Not in GE's case, says Ameen. "FAS 133 hasn't affected the way we hedge--it's just made it more expensive."

It's this sense of having to pay for the sins of others that accounts for the deep resentment toward FAS 133. Many finance executives suspect the new rules have less to do with improving financial statements than with discouraging treasury departments from speculating with derivatives. "Unfortunately, everyone has to pay the price to keep a few people in line," says David Guthrie, manager of financial risk for Bechtel Corp.

That doesn't make it any easier to swallow.

*Andrew Osterland ([andrewosterland@cfo.com](mailto:andrewosterland@cfo.com)) is a senior editor of CFO.*