Derivatives – a 'global solution' is near

Nigel Dealy and Valerio Pace of PricewaterhouseCoopers explore the latest machinations of the world's standard setters for derivatives and other financial instruments.

The last decade has seen a tremendous increase in the use of financial instruments and derivatives by companies. At the same time a number of high profile treasury losses has focussed the minds of regulators and standard-setters on the accounting for derivatives. While different jurisdictions have developed at different paces, we may now be approaching an era when a global 'solution' to the accounting for all financial instruments is just around the corner. Treasurers cannot afford to be ignorant of these developments. In particular, the new breed of standards is no longer about disclosures but focuses on measurement. Thus the broad brush approach to fair values inherent in many of today's disclosures will need to be replaced by a greater sophistication, as they will directly affect a company's profit and loss account and balance sheet.

Where do things currently stand?
In the UK there is currently no accounting standard dealing specifically with the measurement of financial instruments and derivatives. A discussion paper was issued back in 1996 covering both measurement and disclosure but it was decided that only the disclosure aspects would be fast tracked. Consequently, accounting in the UK still allows a degree of freedom in terms of the measurement of financial instruments and derivatives. Generally accepted accounting practice has developed to state that trading instruments should be marked to market whilst hedging instruments should be accounted for in accordance with the underlying item or position. However, the criteria for obtaining hedge accounting are not specified in any mandatory guidance and are the subject to the many vagaries of interpretation.

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Other standard setters have instead recently issued financial reporting standards that address measurement, albeit in a less than comprehensive form. In particular, FASB Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* and *IAS No. 39 Financial Instruments: Recognition and Measurement* have radically changed accounting for any company complying with US GAAP and International Accounting Standards respectively.

Whilst there are differences in the scope and some of the detailed rules between IAS 39 and FAS 133, they have many common characteristics which make them very different from current UK GAAP. These include:

- all derivatives are marked to market – even those used as hedges;
- results of marking to market are taken to earnings unless hedge accounting provisions apply;
- hedge accounting can only be applied in limited circumstances;
- stringent designation and effectiveness rules need to be met to allow hedge accounting;
- hedge accounting results in either the change in the mark to market value of the derivative being parked in 'other comprehensive income' (the US equivalent of the Statement of Total Recognised Gains and Losses) or in the underlying position being revalued and the change in value being taken through the profit and

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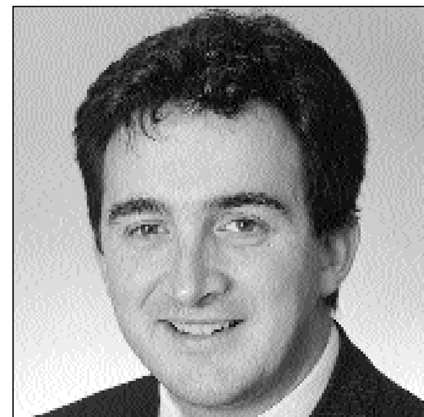

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loss account to match the change in value of the derivative;
- there is no synthetic accounting; and
- hedge ineffectiveness flows through earnings.

Companies who report under US GAAP and/or IAS will no doubt already be aware of the above and have started their preparations accordingly. For a typical 31 December year-end company, implementation of both standards will be required from 1 January 2001.

The financial instruments joint working group (JWG)

The JWG was formed some two and half years ago as a means of pooling resources from the International Accounting Standards Committee (IASC) and nine national standard-setters, including the UK and US. Its task is to develop proposals for a credible, comprehensive and internationally harmonised accounting standard on financial instruments.

The participating standard-setters have agreed recently that the results of the JWG's deliberations should be published simultaneously in all 10 jurisdictions as a draft standard on 31 October 2000. Allowing for comments, the UK's Accounting Standards Board (ASB) could follow that with an exposure draft in 2001 and its own standard in 2002. It is hoped that the IASC and the FASB will eventually replace IAS 39 and FAS 133 respectively; though the timing may well depend on their appetite (and that of their constituents) for making a change so shortly after implementation of these interim standards. Uncoordinated implementation by the standards-setters in this important area is the nightmare scenario for companies wishing to access the world's capital markets, as the JWG's expected proposals are significantly different from FAS 133 and IAS 39.

So what are the JWG's expected proposals? In summary:

- all financial instruments (including derivatives) measured at fair value on balance sheet and all changes recognised immediately in income; and
- no hedge accounting.

A seemingly simple model. At a stroke, it does away with the unbelievably complex hedge accounting provisions and the 'sin bin' penalties, if management break the rules, of IAS and US GAAP. However, the JWG's model has its own problems. For example:

- what does 'fair value' mean?;
- how is it to be determined?; and
- how to deal with own creditworthiness?

The definition of fair value is central to any discussion of which products are difficult to fair value. In particular, different valuation methods, such as decomposition and risk neutralisation, give rise to different answers when compared to replacement cost. Hopefully, the eventual guidance will address whether an instrument should be valued as a whole or by reference to its constituent parts.

For example, an illiquid or thinly traded convertible fixed rate bond might have a significantly different fair value from that at which it is traded and that using a risk neutralisation approach. The latter might be calculated as the sum of the values of a floating rate note, of a floating to fixed interest rate swap and of the equity option. However, such an approach may be too radical for the JWG as valuations may become a function of the intellect and innovation of the company and its advisers.

Fair values may be obtainable by reference to traded identical or similar instruments. However, this is not always possible and other valuation techniques will be required and more than likely involve the use of a model. It is a misconception that information merely has to be input and for the model to produce the answer.

There are four main inputs in the valuation process:

- the risk positions taken;
- the model selected;
- the parameters at a point in time; and
- valuation adjustments to reflect risks that are not captured by the valuation model.

All involve human intervention and are subjective, which means different companies will calculate different values for the same instrument. Other factors that make valuations variable include, optionality, duration, illiquidity, concentration, impact of tax, and uncertainty. So what is fair value and is it permissible for different companies to report different values?

Another aspect of the JWG's proposal on fair value concerns the company's own creditworthiness: should changes in its credit rating affect the reported value of its borrowings? The consequence of a fall in credit rating would mean a lower balance sheet debt amount but a gain in income. It appears that the JWG is unswayed by the practical difficulties or even a conceptual argument, such as the gain is matched by an impairment of internally generated goodwill, and will require that changes in own credit risk are reflected in the fair value of borrowings. However, its one concession for untraded debt may be that a reassessment of the own credit risk element of fair value would only be required where there is demonstrable evidence that a significant change in the company's credit rating has occurred. But is even that going to be palatable, or understandable, by the directors who have no intention of repaying the debt before maturity?

On hedge accounting, the JWG's stance is that it is not required if both the hedging instrument and the hedged position are measured at fair value and changes therein are recognised immediately in income. However, this ignores situations where a hedging instrument is hedging a non-financial instrument or is, say, an anticipatory hedge of next year's foreign currency sales. Because the JWG cannot find conceptual support for allowing hedge accounting in these circumstances, and does not wish to invoke the complexities of IAS 39 and FAS 133 provisions on the matter, it is proposing to prohibit any form of hedge accounting. Management would be encouraged to explain its risk management policies and the effects these had on the reported results (including hedge gains and losses). This, of course, would be a recipe for the operating and financial review to sprout proforma accounts, drawn up on management's preferred bases, coupled with the commentary and, in effect sidelining the 'real' numbers as an irrelevance.

What next?

So far the ASB has steadfastly refused to adopt IAS 39 into UK GAAP. Left alone it would prefer to proceed to an FRS sometime in 2002 based on the JWG's proposals. However, the European Commission aims to amend the fourth

and seventh EU company law directives by the end of 2000 to allow, or potentially require, companies to measure some financial instruments at fair value. Member states would be expected to change their national legislation in 2001 but may be able to limit the scope, for example, to only listed companies or require that it is applied only in consolidated accounts.

Although the draft EU legislation would permit hedging accounting it does not define it (or indeed provide any other definitions) or set parameters, such as documentation or correlation, to permit such accounting. The amended directives would seemingly rely upon accounting standards to provide the 'rules'. In the absence of any UK standard on the subject, it could mean the ASB having to rush out an equivalent to IAS 39.

This would have far-reaching consequences for the UK, not least the need for systems changes identified below. Amongst other issues that will have to be addressed is the effect of including 'unrealised' gains in the profit and loss account and how this affects the distribution of profits.

The implications for corporates

All companies that are engaged in the use of financial instruments and derivatives should focus on the impact that these developments will have on their organisation. Companies that report under US GAAP or IAS should already have reviewed strategy and systems. Companies reporting under UK GAAP need to be aware of the impending changes.

For heavy users of derivatives, it takes significant time and effort to determine the impact of the proposed changes on a business and to devise a strategy to implement the new rules. Co-ordination and input from several departments within a company is vital, including accounting, tax, finance, treasury, risk management, legal and the information-systems function.

Based on US experience with FAS 133, companies will typically need to:

- assess the impact of the proposed standards on the financial statements. This will include evaluating the size of any transitional adjustments and the ongoing earnings volatility;
- investigate alternative risk management strategies and derive a recommended approach. Examples include no change, changes in documentation and designation processes, change in hedging methodologies and/or a 'full' change in treasury and risk management policies and processes;
- design of the new treasury policies, processes and systems configuration; and
- construction and roll out the above, including relevant training.

Implementation is neither cheap nor easy. ■

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