FAS 133/138 – the systems perspective

Mona Henriksson and Riitta Kuusela of Trema Group explain how they helped clients prepare for FAS 133/138 compliancy.

FAS 133/138 presents treasurers with two practical issues. The first is to understand exactly what they must do to comply with the new standard. The second is to ensure compliance is achieved as cost-effectively as possible.

The treasury management system comes into consideration immediately, as the treasurer will want to automate as many as possible of the new procedures, accounting and reporting requirements.

One of the principal issues for a systems supplier faced with the first request from a company to make their system FAS 133/138 compliant is how to distil the particular individual requirements of one clients to meet the needs of the majority. Some of the issues to be considered are:

- to understand as fully as possible the implications of the legislation by building a comprehensive knowledge base;
- to stay flexible by developing tools and functionality that can be used by clients to measure and demonstrate compliance, rather than impose a strict, uncompromising process; and
- to recognise that systems do not make for compliance – but rather they support a client in achieving compliance.

Building a knowledge base

The classic approach to functionality definition is to review the universe of possible requirements as well as working with pilot customers to develop business specifications that feed into development specifications for review and discussion. These development specifications are then coded, tested and revised as necessary.

It quickly became clear that, based on a reading of the available literature at the time (around May 1999), neither our pilot customers nor we had access to the necessary level of detail. And only leading edge customers were ready to address the issues. It was not just a case of getting information – what we had to do was to actively interpret and challenge the existing knowledge base in order to understand how the high level FAS requirements would impact the individual transactions, accounting entries, effectiveness calculations, and so on.

> The introduction of FAS 133/138 is necessarily an evolving systems story, because it is an evolving regulatory story

In order to achieve this, we hired consultants (PricewaterhouseCoopers) for an intensive one week's workshop in Boston during summer 1999. We spent the days teasing out the practical implications of the standard with our teacher, and the evenings recapturing the discussions and trying to work out what this would mean for our software. By working in this way, we were able to arrive at a view of the requirements which could be adapted for all our clients.

Inevitably, as discussions of FAS 133 were still continuing, it was not possible to have definitive answers. However, the deadline for implementation of the standard was extended and FAS 133/138 went into effect for fiscal years beginning after 15 June 2000 – that is, for calendar year companies, adoption is no later than 1 January 2001. We were lucky that, in spite of this extension, our pilot customers were keen to press ahead and not lose the momentum of our earlier joint good work.

The systems issues to be addressed

Every system is different and it is not particularly enlightening to discuss the minutiae of technical changes. However, there are common issues in every treasury system so that users can comply with the standard.

The bulk of the systems implications of FAS 133/138 are contained in the special or hedged accounting requirements. These represent exceptions to the standard, designed to allow companies to avoid significant volatility in their income statements as a result of a gain or loss from a derivative in a particular quarter.

The impact of these hedge accounting requirements varies considerably from one company to another. Some chose not to use them. These companies, prefer to

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Caterpillar – planning for compliance

Caterpillar Financial Services Corporation, a wholly-owned subsidiary of Caterpillar Inc, provides a range of financing alternatives for Caterpillar machinery and engines, Solar gas turbines, lift trucks manufactured by Mitsubishi Caterpillar Forklift of America Inc, and non-competitive related products. The firm also extends loans to customers and dealers. Cat Financial has offices and subsidiaries located throughout the Americas, Asia, Australia and Europe with headquarters in Nashville, Tennessee.

Early planning and close collaboration with its software vendor are the hallmarks of Caterpillar's FAS 133/138 preparations.

FAS 133 was at the first draft stage when Caterpillar Inc. (Cat) and its wholly-owned subsidiary, Caterpillar Financial Services Corporation (Cat Financial) started to consider the systems implications of the standard in November 1998.

Caterpillar has remained in the vanguard of work towards implementing the requirements, including hedge accounting for an active commercial paper programme.

Although Cat Financial has higher numbers of derivative contracts than Cat, dollar amounts in derivatives are roughly the same for both entities. It made sense to work together, and a joint team was established with input from Caterpillar's auditors. The decision was made to minimise potential volatility in the income statement by using the hedge accounting procedures defined in the standard. The onerous nature of the accounting and reporting requirements meant the organisation needed to automate as much of the work as possible – and this quickly highlighted the shortcomings of their existing debt and derivatives systems.

So FAS 133 was the catalyst for a joint search for a new treasury management system, and the issue was high up the list of requirements in discussions with potential suppliers.

After selecting the Finance KIT system, Caterpillar worked with Trema to interpret the evolving requirements of the standard and develop the software to support it. In March/April 2000, Caterpillar began testing the FAS 133 functionality of the software. The biggest issue for Caterpillar has been the hedge effectiveness testing, and Cat Financial contributed vigorously to the discussions on which of these three possible methods should be used.

For Caterpillar, as for many other organisations, implementing FAS 133/138 is a costly business, even with the support of compliance-ready software. "To reach this point, we've had the equivalent of at least 1.5 people dedicated to this full time for the last year," says Sally Holland, Senior Financial Analyst for Cat Financial. And the work is not over yet.

As the Derivatives Implementation Group meets to resolve outstanding issues ahead of the January 2001 implementation deadline, Caterpillar, for all its early planning, expects 'one more big push' will be needed to get all its hedge designations in place. After euro implementation in 1998 and Y2K in 1999, software suppliers and companies are expecting a busy holiday season for the third year running. ■

accept the additional volatility in the income statement, rather than assume the extra work/costs associated with hedge accounting. Others focus on hedge accounting for particular instrument types – foreign exchange, interest rate or, as in the case of Caterpillar, commercial paper (see case study).

We developed a total list of roughly 30 system requirements and, from this, identified four main systems issues, which were: how to create and handle the hedging relationships; how to create flexibility in calculating hedge effectiveness; how to create accounting entries for the hedge items and their hedges; and how to make reporting requirements less onerous for our users.

Hedge accounting

The hedge accounting rules laid down by FAS 133/138 are complex and labour-intensive, so it is important to automate the accounting procedures as far as possible. Also, there were new levels of granularity necessary in the accounting entries. There are at least four main requirements to be addressed:

- the Financial Accounting Standards Board (FASB) requires that institutions distinguish between derivative transactions that are designated as a hedge, and derivative transactions that are not designated as a hedge. As it is possible to only designate a percentage of the hedged item, or the hedging transaction, to the hedging relationship, the requirement is to split the unrealised result of one transaction into a designated and a non-designated portion, and account for them separately;
- the effective portion of the gain or loss on a derivative designated as a cashflow hedge is reported in other comprehensive income (OCI), and the ineffective portion is reported in earnings. This means it is necessary to further split the designated portion of the unrealised result into 'effective' and 'ineffective' portions;
- FAS 133 para. 30b requires that a maximum OCI be calculated. If the maximum OCI is exceeded, the excess amount must be booked from OCI to earnings; and
- there are varying requirements for discharging the OCI balance into earnings, for example, on a specified date, over a specified period, or according to the hedged item. The implication of this is that it is necessary to generate accounting entries for transactions which have already matured.

An evolving story

The introduction of FAS 133/138 is necessarily an evolving systems story, because it is an evolving regulatory story. As late as March 2000, the FASB published an exposure draft of the amended FAS 133. This only became the official standard, now known as FAS 138, in June this year. At the time of writing in October, a number of new questions are still up for discussion.

At the same time, International Accounting Standard 39, which imposes similar requirements to FAS 133/138, is waiting in the wings. ■

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