



15 June 2000 – another big day for your computer diary

This is the day FAS 133, a US accounting standard, comes into effect. Les Halpin of Integrity Treasury Solutions looks at its far-reaching implications.

Just when we thought we could devote all of our energies to coping with even more exotic instruments and rolling back the frontiers of cyberspace for the benefit of human kind (or at least treasuries around the world), along comes a new date – 15 June 2000. No, not another derivative of the Y2K bug (or passing microbe as it turned out), but something much more sinister and far-reaching.

June 15, 2000 (as my US colleagues would write it) is the date after which Financial Accounting Statement 133 (FAS 133) comes into effect for all US financial reporting entities. That is all organisations using US GAAP (US Generally Accepted Accounting Principles) will have to conform to this accounting standard for all fiscal years starting on or after 15 June of this year.

Although most non-Americans try to avoid things from this side of the Atlantic (I am writing this from the 55th floor of a skyscraper in Chicago) FAS 133, like McDonald's and Friends, is going to be hard to escape.

Without repeating too much of the essential information with which I am sure you are already becoming familiar, FAS 133 is going to ensure that all organisations who come anywhere near the Securities and Exchange Commission (SEC) have to report on their derivatives in their financial statements. It is easy to see why the SEC and others have been keen to see this happen given some of the very high profile financial disasters that have been linked to the use, and abuse, of financial derivatives.

Principal requirements of FAS 133

The principal requirements are:

- all FAS 133 derivatives should be reported in the financial statements;

- all FAS 133 derivatives should be recognized at fair value;
- gains or losses from measuring the FAS 133 derivatives at fair value must be recognised in current earnings; and
- special 'hedge accounting' rules have been introduced to offset the gains and losses in accepted hedge relationships. This reduces the increase in earnings volatility that would have been introduced by a pure 'fair value' approach.

The above rules are not only far-reaching in their embrace, they also impose significant obligations on organisations wishing to avail themselves of the hedge accounting rules. Every derivative and the item it is hedging will have to be specifically identified by the time the hedging contract is undertaken. This would then need to be linked into the organisation's overall risk management policy to show it conformed and was a part of the strategy. Finally, organisations will have to show that the hedge was expected to be 'effective' as well as demonstrating that



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effectiveness in practice over the life of the hedge.

The system implications

You may have thought that it is only the last of the four principles which would cause any real trouble in practice, with special exceptions to the rule. Unfortunately even the first three are open to different interpretations.

There is no simple definition of a derivative which allows us to be prescriptive in the system coding. It can depend on:

- the type of instrument, asset or index that is the object of the contract;
- whether or not the contract contains a provision for or there is opportunity for net settlement (ie cash settlement);
- whether the purpose of the contract is an ordinary purchase/sale;
- the practicality of converting into cash any instrument, asset or goods which might be transferred under the contract; and
- the size of the transaction.

(As an example of the difficulties facing everybody involved in treasury activities, I would refer you to FASB's own Statement 133 Implementation Issues A.10, which has yet to be finally resolved but was released in November 1999).

An even more difficult area relates to embedded derivatives which may exist in non-treasury instruments such as bonds, insurance policies or leases. These have to be broken out from their host contract and accounted for within the FAS 133 rules. (See Statement 133 Implementation Issues A.1 for an interesting example of how complex things could become.)

'Marking-to-market' – something many systems do – does not equate precisely with the FAS 133 definition of 'fair value'. The ability to import 'valuations' to override formula based system calculations has to be built in, although a counterparty's valuation is exactly where a number of the derivative disasters have come from.

Where the big problems lie

It should be clear from the above that there are already a number of minefields lying in wait from the first three 'straightforward' principles. However for treasuries (and in consequence for software suppliers) the real problems lie in the area of the special 'hedge accounting' rules. This area I have likened to trying to write a system to replace English law. There are certain common principles which apply until they are excluded, but then there are exceptions to those exclusions and so on and so on, on a case by case basis. Just like the law, all of this is being updated as we speak as new examples are raised, which means certain key areas have changed very recently as a result of discussions within the FASB.

Broadly speaking the hedge accounting can be split into two categories – fair value hedges for known cashflows and on-balance sheet items, and cashflow hedges for forecasted items. With the former the effect on the derivative and the item being hedged appears on the P&L at the same time. A good hedge means that movements in one will be cancelled out by an opposite move from the second. With a cashflow hedge the result from the derivative is put into the balance sheet (in other comprehensive income, known as OCI) until the forecasted risks appear in the profit and loss. If the derivative has hedged the forecasted cashflows well then the OCI balance should match the risk element and offset its effect in the profit and loss.

Simple enough you may say, but what can count as either of these types of hedges, how much documentation is required, how do we show a hedge is

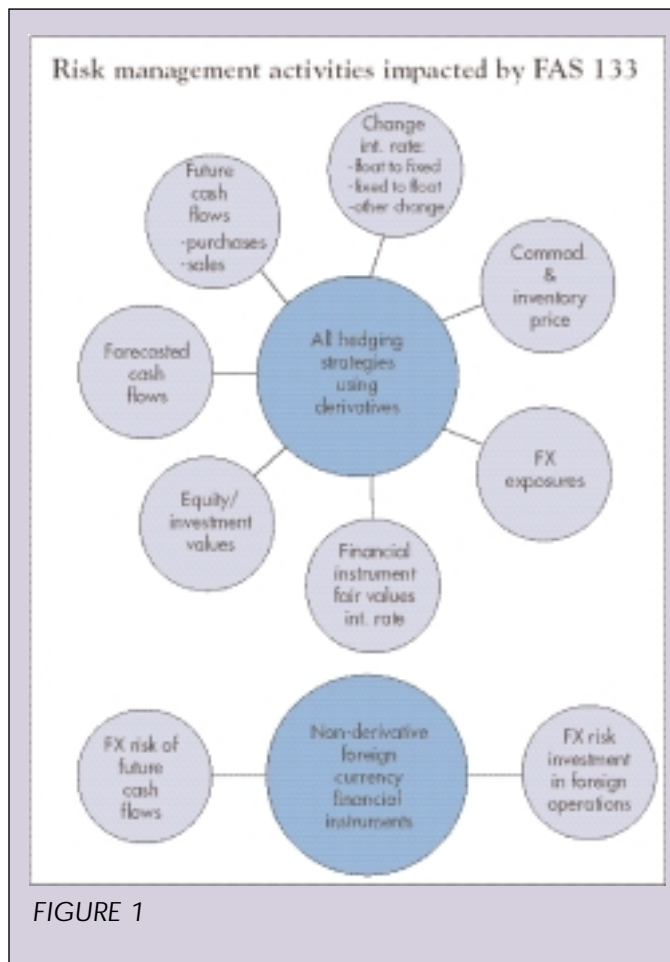


FIGURE 1

effective, and what happens if it stops being effective at a later date? From a systems point of view what if one hedged item is covered by many derivatives or vice versa? You can see how complex this is all getting. The whole area of ex-ante effectiveness testing could easily require a major system of its own.

Tackling the problem

It is vital to work with accountants for education guidance and users for the practical aspects of development.

FAS 133 is turning out to be a rapidly evolving, difficult 'standard' with the 'devil in the detail', which no systems provider could afford to get wrong.

Despite the fact that 15 June 2000 is rapidly approaching, many companies are only now seriously evaluating the impact FAS 133 will have on their treasury strategies and operations. Many will be implementing interim solutions until they have had a chance to go through the full implications of FAS 133 on their results if they maintain their current range of hedging strategies and associated instruments. It is better to focus on

the core requirements of FAS 133 rather than trying to develop a 'fully compliant' solution, which would be the Utopian ideal

Implementation of FAS 133

FAS 133 is going to make a major change in the way many US organisations view hedging and in their use of derivatives. We can immediately see that portfolio type hedging will have problems under FAS 133 because of the need to identify specific hedges. Many other hedging strategies will come under the spotlight because of effectiveness testing, which is what was planned. 'Risky' strategies will now be identified as such, but will FAS 133 also stifle innovative approaches to managing risk because of the documentation requirements, or the uncertain way in which a strategy/derivative could be treated?

For software suppliers FAS 133 has created a new headache as well as a new opportunity. A headache because of its complexity and the uncertain application of the rules. An opportunity as it provides further reasons for establishing an integrated database with all of your derivatives and hedged items, rather than as a collection of datafiles and spreadsheets, which will not give you the FAS 133 peace of mind.

Finally, another date to wake up all those who rejoiced at not living in the US – 1 January 2001. This is the date on which IAS 39 is destined to become effective. IAS 39 shares many of the features and objectives seen in FAS 133 and will also apply to all European companies as well as many others internationally. ■

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Recommended reading

FAS 133: Accounting for derivative instruments and hedging activities, FASB
FAS 137: Amendment to FAS 133, FASB
Also look at www.fasb.org and www.fas133.com for the latest information and analysis relating to FAS 133.