Bringing financial instruments to account

The accounting profession is reeling from accusations invoked by investors and regulators following recent corporate collapses. As JOHN KIDD explains, accounting standards are only just catching up with some existing financial practices. The new accounting rules for financial instruments provide a case in point.

There is no doubt that the Enron scandal will have an impact on how companies account for transactions. It would appear that it was Enron’s failure to comply with accounting standards that led to the plummeting share price and ultimately the delisting of the company.

While the complete Enron story will unfold over the next couple of years, what is apparent to date is that much reliance is still placed on published financial information. The information disclosed in financial statements is driven by the accounting standards and accordingly changes in accounting standards modify the behaviour of companies.

The changes in the accounting treatment for financial instruments are having dramatic ramifications around the globe. Amazingly, in this era of corporate governance, this has been an area without an accounting standard that specifies the rules for measuring and accounting for financial instruments. These changes have ramifications on:

• What financial instruments companies buy;
• How banks/merchant banks will structure transactions in the future; and
• The risk management practices of companies.

Changes in financial instrument accounting

There have been significant changes in the accounting for financial instruments in recent years, although Australia has been partially insulated from these to date.

The most significant change was the 1998 introduction of the US accounting standard FASB no. 133 “Accounting for Derivative Instruments and Hedging Activities” (therein referred to as FAS 133)—see details below.

This standard has had a significant influence on the global financial community as this is the first standard to specify how derivatives should be measured and accounted for in the financial statements. This influence is set to increase as the International Accounting Body has introduced IAS 39 “Financial Instruments: Recognition and Measurement” which contains much of FAS 133. There is currently a project to revise IAS 39 to address some of the key weaknesses in its present form before it is widely introduced into Europe over the next couple of years.

Australia currently has no standard governing the measurement of and accounting for derivatives. In relation to disclosure of information on financial instruments, AASB 1033 requires companies to disclose their accounting policy in conjunction with sufficient information to enable investors to understand the exposures that arise from the financial instruments undertaken by the company. Needless to say, there is wide divergence in the level of information currently presented in this note.

On the basis that IAS 39 is still in the infancy phase, Australia has rejected the adoption of the standard, and has been waiting for the all-comprehensive
“Fair Value” accounting standard—an international draft that was released for comment last year.

This standard would require all financial instruments to be fair-valued with the financial impact recorded in the profit and loss account. This proposal has the side defect of abolishing all forms of hedge accounting. Needless to say, the overwhelming response to the standard is that it is ahead of its time, and it will produce meaningless performance information and accordingly be detrimental to the concepts of financial reporting.

In light of the global feedback to the “Fair Value” accounting standard, it is now probable that Australia will reconsider embracing IAS 39 in the interim whilst the “Fair Value” approach is being reconsidered. A draft standard is expected in Australia later this year.

FAS 133
FAS 133 is the first accounting standard in the world that has been introduced to specify how to account for derivative instruments. It is not intended to cover all financial instruments, but to be limited to derivatives.

The standard is effective for all US GAAP reporting companies for the first accounting period commencing after 15 June 2000. Essentially, it must be implemented from the start of the first accounting period. The standard is also applicable to some Australian companies as a result of their US GAAP reporting obligations.

FAS 133 requires all derivatives be recorded at “fair value” in the balance sheet, and the gain or loss associated with the derivative be recorded in the profit and loss account unless the derivative can satisfy the FAS 133 definition of a “hedge” (including the associated documentation requirements). For most companies, this is the first time fair values will be booked in the accounting records, and it is a dramatic change from the historical cost accounting approach of having derivatives off balance sheet.

Positive impact of FAS 133
With the various disasters associated with derivatives occurring around the world and their proliferation to the stage where it is actually unusual to find major companies without derivatives, an accounting standard defining the appropriate treatment for derivatives is long overdue.

Furthermore, the standard also examines the risk management concepts behind derivatives and requires:

- All derivatives to be recorded at “fair value” in the accounts. This has forced companies to be in a position to be able to value derivatives which naturally assists in understanding the instruments.
- Documentation on the hedging relationship and the company’s risk management objective and strategy for entering into the hedge including identifying the hedged item.
- Documentation on every hedge at inception or upon the adoption of FAS 133.
- Documentation on each hedge of the specific risk being hedged and specifically how the entity will assess and measure hedge effectiveness.
- Documentation that the hedge is going to be highly effective in achieving offsetting changes to fair value or cash flows attributable to the hedged risk; and
- Ongoing documentation (at least quarterly) on the assessment of the hedge and its effectiveness retrospectively and prospectively.

Many of the derivative disasters occurred because:

- Derivatives were not on the balance sheet;
- They were not fair valued and in some instances the company did not have the ability to fair value the derivatives;
- The company’s risk management strategy was not appropriately documented; and
- The financial controller/ auditor had no guidance on how to account for derivatives.

The above requirements will go a long way to addressing many of the control inadequacies to date. While some of the documentation might be seen as excessive, especially in portfolio hedging arrangements, companies have been able to adapt to the standard by building into their processes standard measures to satisfy the requirements.

Difficulties with FAS 133
The reason it has taken so long to establish a standard is because it would take the wisdom of Solomon to figure out how to satisfy every company’s specific requirements regarding their use of derivatives.

In the absence of Solomon, specific rules have been created which inevitably will cause heartache to certain companies. The standard has focussed on creating relatively simple rules that unfortunately have negative consequences on certain transactions. The following are some of the issues raised with FAS 133.

Sold options
These have basically been given the thumbs down, and will not be considered a hedge except in certain collar arrangements where the other side of the collar has identical offsetting parameters.

Portfolio hedging
Portfolio hedging is only a possibility when the portfolio consists of “similar items”. For example, a debt portfolio could only be hedged if the portfolio was stratified into like items; eg items for which for a given movement in interest

Failure to provide the documentation may mean instant disqualification of the transaction as a hedging instrument.
rates the fair value of each instrument fluctuates in line (plus or minus 10%) with the portfolio. The “similar items” requirement means that in most instances purchases and sales, assets and liabilities cannot be in the same hedge portfolio, as they would not satisfy the similar characteristics test.

Central treasury operations
The portfolio hedging requirements significantly restrict the operations of a central treasury. Fortunately, exceptions have been given for a central treasury in managing foreign exchange risk; however, the rules associated with the exceptions have caused significant difficulties for the central treasurer, as the requirements include:

- All net positions consisting of internal derivatives (can include purchases and sales) are not to be hedged with affiliated companies unless the same currency and must mature in the same 31 day period.
- Each net position must be covered within 3 business days after designation of the internal derivatives as hedging instruments; and
- All non-derivative contracts are to be excluded from the determination of the net foreign currency exposure.

These restrictions make it very difficult for a central treasury to hedge group transactions on anything but a back-to-back basis with an external party. Fortunately, given the requirement that subsidiaries maintain the full documentation of FAS 133, the central treasury could well just add to the administration and therefore cost to the organisation as opposed to the opposite.

Trading divisions
FAS 133 requires that for a derivative to be classified as a hedge it must be undertaken with a third party. Hence, if the group has a trading division (company) that enters into derivatives with its subsidiaries, these derivatives will not be recognised as hedges in the group accounts unless the trading division enters into offsetting hedges immediately with a third party.

FAS 133 is an interim step
Whilst FAS 133 is a significant step forward, a fundamental flaw remains in the standard. The standard is based on a mixed attribute model in that some financial instruments are at fair value and others aren’t.

Derivatives, as the name suggests, derive from physical instruments and, accordingly, have the same characteristics as the physical instruments. Unfortunately, the accounting rules specified for physical instruments can be totally different to the equivalent derivative. For example, an investment in a bond, which is financed by floating debt, is similar to a bond futures contract. Unfortunately, the futures contract is marked to market whilst the physical equivalent is held at cost if it is a held-to-maturity security.

This inconsistency means that companies with similar risk profiles may have different results due to the physical vs. derivatives instruments used to create the profile.

Accordingly, the US accounting standards boards see FAS 133 as an intermediate step. Their long term intention is to move to a “Fair Value” standard whereby hedge accounting is abolished completely and replace with a standard that “fair values” all financial assets and liabilities, including derivatives. Given the feedback to the initial draft this will still be some way off.

IAS 39
IAS 39, as mentioned, is similar to FAS 133 and faces many of the issues associated with FAS 133. Fortunately, by the time IAS 39 becomes an exposure draft in Australia, it is likely that the various issues associated with the introduction of FAS 133 would have been resolved, thus making for a much easier implementation.

Impact on accountants, risk managers and merchant bankers
The profound nature of the various financial instruments standards mean that risk managers and merchant bankers must fully understand the new standards, as failure to fully understand the standards could result in unintended volatility in the profit and loss statement.

Furthermore, unlike other standards where it may be possible to correct matters retrospectively based on the substance of the transaction, much of the new standards require explicit documentation at the inception of the transaction. Failure to provide the documentation may mean instant disqualification of the transaction as a hedging instrument.

As with any changes, new opportunities also exists for merchant bankers to package instruments so as to bypass the complex fair value accounting requirements.

The biggest single change will be on accountants who face the most significant change ever in terms of the shift away from historical cost towards fair value. Most accountants will not have the specialist expertise or the systems capable of valuing financial instruments or maintain the appropriate hedge documentation in the short term. Accordingly the next couple of years could prove a challenging period.

For those skilled and prepared for the challenge there will be some great opportunities.