INTRINSIC VALUE/BY ROGER LOWENSTEIN

Corporate America Bullies FASB, Part II

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Corporate America has frightened individual accountants into meek submission; the next step has been to go after the group that makes the rules.

A few years ago, when the Financial Accounting Standards Board proposed that companies recognize the cost of executive options, corporate lobbyists steamrollered Congress and forced the FASB into a timid retreat.

Now, executives are at it again. After years of study, the FASB is about to require that companies recognize derivatives on their balance sheets at market value. Most banks and many industrial concerns have squawked. Moreover, they have threatened that, if the FASB doesn't back down, they will go to Congress. Edmund Jenkins, the new head of the FASB, properly recognizes this as a threat to his charter.

Edmund Jenkins

Critics of the FASB give lip service to the notion that a private body, insulated from politics, can do the job of setting rules better than government. But if the losers get redress in Washington for every rule they deem imperfect (and believe me, without imperfect accounting rules there wouldn't be any at all), Mr. Jenkins may as well call it quits.

The idea behind the derivatives rule is simple. Derivative contracts are basically bets on interest rates, currencies or commodities. As **Procter & Gamble** Co. and others have learned, they result in real cash obligations or rewards. A balance sheet that doesn't include them (or any big assets or liabilities) is sorely incomplete.

In practice, it isn't simple. Remember the canny farmer, who locked in his profit by selling corn futures in advance of the harvest? If the price of corn rises, he has a loss on his futures contract, but his corn is worth more. So the FASB has said, fine, if you were using futures to hedge your crops, you can adjust their value simultaneously and thus not affect your profits.

But what if the farmer, partly hedging and partly playing a hunch, sells futures representing twice the amount of his crops? Or what if, being canny as we said, he trades in wheat futures, where the action seems hotter?

These imperfect hedges could result in profits or losses not necessarily balanced by the cash crop. The real world, in which companies trade derivatives in dizzying varieties, presents many such imperfect hedges. They should show up on companies' books, and they will.

Now, an example closer to the current controversy. Suppose a bank uses interest-rate derivatives to hedge the value of loans. If rates move down, the bank loses on the derivative, but it can mark up the value of its assets—in this case not corn but loans. Thus no effect on its equity and no problem.

But suppose the bank uses derivatives to lock in its future funding costs. And suppose rates fall. In the short term, the bank has a cash loss on the derivative. The bank expects to make up the loss by paying less to future depositors—but an expectation is not an asset. Thus, under the rule, it has no corresponding asset to mark up and, for the moment, the bank suffers a net loss to equity.

The knock on the FASB is that bank balance sheets will become more volatile, but the accounting doesn't create volatility; it only unmasks it. Nor does the accounting prohibit derivatives. It will, however, force companies to think about—and decide in advance—whether and what they are truly hedging and why.

The suspicion here is that derivatives are overused anyway. Corporate America is hooked on managing earnings, and it uses derivatives (in part) to do so. Smoothing out bumps in the P&L may please Wall Street, but it hardly serves to give a truer picture of a business—and like any insurance, it comes at a cost.

Some derivative dealers and big industrial users quietly admit that the rule, which the FASB has amended, isn't so bad. Banks, which are sensitive to changes in capital, are still unhappy—as is their chief regulator, Alan Greenspan. The complications are rich, because the FASB is pushing banks to record derivatives at market value, but not every asset can be repriced every day. "What's the desired result of accounting—to mark every institution to its liquidation value, or to help investors understand cash flows?" asks Carlos Mello, of People's Bank.

The question is fair, but banks were similarly panicked when the FASB forced them to record the fa[ir] value of bonds. Mr. Mello admits that banks learned to live with that one.

And the fear, raised by Mr. Greenspan, that the rest of the world would reject the U.S. rule was shot down this week, when the head of the international standards body urged his group to accept it as an "improvement" in financial reporting. So the question now is whether unhappy bankers in the U.S. will try to force the issue in Congress.

"Be careful what you wish for," notes Mr. Jenkins, who vows not to back down. If the FASB were humbled a second time, its loss of credibility might spur the Securities and Exchange Commission to take over the job. Anyone for government control?