New Accounting Standard Gets Mixed Reviews

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Depending on whom you ask, a new accounting rule either opens investors' eyes to a stash of useful data, or it unjustly makes companies' earnings reports look like a crap shoot.

The rule changes the way companies report their holdings of financial contracts known as derivatives.

On one side of the disagreement over the rule's effect, pharmaceuticals giant **Merck** & Co. and **Fannie Mae**, the nation's largest financing source for home mortgages, are at the head of a pack aligned against it, claiming that too much unnecessary earnings volatility will result. They are pushing for changes that they say would provide a less volatile representation of the effect of using certain derivatives like options, which play a significant role in some of the strategies the companies use for hedging certain kinds of risk.

On the other side of the debate are advocates who say the changing role and increasing sophistication of derivatives justify revamping the way companies report their use.

Hanging in the balance: potential fundamental changes in the way companies manage risk and the financial information investors get to make decisions.

Specifically, the new rule, Financial Accounting Standard 133, requires that derivatives be marked to market to reflect the value at the date of the financial report. Fluctuations in value are reflected in per-share earnings.

Under the treatment being scrapped, companies record options on their balance sheets at historical cost, and this cost is amortized over the option's life; some additional information is sometimes included in footnotes.

While the FASB is considering some changes in advance of the rule's Jan. 1 implementation date for most companies, the new accounting treatment already is starting to make itself felt at companies with fiscal years starting July 1. Last week, **Microsoft** Corp. took a $375 million one-time charge in its fiscal first quarter ended Sept. 30 to comply with the rule. The charge is a transition adjustment, reflecting the difference between the cost at which the software giant obtained its derivatives and their current fair market value. Microsoft reported net income of $2.21 billion, or 40 cents a diluted share; without the charge, it earned $2.58 billion, or 46 cents a share,

In recent weeks, **Dupont** Co., **Eastman Chemical** Co., the **Federal Home Loan Bank System, Freddie Mac, McDonald's** Corp. and the National Association of Real Estate Investment Trusts have shown support for the changes urged by Fannie Mae and Merck.

In a letter to the Financial Accounting Standards Board, the accounting industry's rule-making body, Al Wargo, Eastman Chemical's treasurer, estimated that the company's quarterly per-share earnings could fluctuate as much as 100% in either direction, assuming profits of $1 per share. "This means that Eastman's EPS [earnings per share] could fluctuate between $0 and $2/share solely due to the FAS 133 accounting for our desired option-based hedging programs," he wrote. The company posted net income of $1.12 per diluted share in the second quarter of 2000.

Options are an increasingly popular way for corporations to hedge exposures to fluctuations in interest rates, foreign currencies or commodity prices. But options themselves can display fairly volatile swings in day-to-day prices, and Mr. Wargo says that FAS 133, ironically, creates an incentive for companies to use alternate hedging methods with "greater negative consequences."

For example, he says the rule nudges companies like Eastman to sell euros forward to lock in a price, rather than to use options to hedge risk against the euro. A forward transaction would generally create less profit-and-loss volatility under the new accounting rule, experts say. But if the euro's value runs counter to the hedger's bet, the hedger is stuck with an unattractive transaction.

By contrast, because an option conveys the right but not the obligation to sell or buy, the cost is limited to the price paid for the option if the bet proves wrong. Some consultants argue that options protect the corporate hedger from forecast errors and are better hedging tools when rates or currencies are at historical lows or highs.

"Anything that's this far-reaching is going to have some glitches," Mr. Wargo says of FAS 133. "This is one of them."

In short, what Fannie Mae and Merck are asking is that the FASB allow corporations to amortize an option's premium over its life in reported income if they can demonstrate that they plan to hold the option until maturity. Any changes in the difference between the premium's fair value and the amortized value would be posted to "other comprehensive income," rather than to earnings.

For all the angst among financial chiefs, analysts and investors generally applaud the rule. "It's about time," says Ned Riley, chief investment strategist at State Street Global Advisors in Boston, adding that he prefers to "have everything in front of me rather than dig through the third footnote on some back page to get this information."

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