S&P Takes Rare Stand Against FASB Over Plan to Assess Risk of Derivatives

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NEW YORK – In an unusual move, Standard & Poor's Corp. has sharply criticized an accounting proposal aimed at giving investors a clearer idea of the riskiness of certain derivatives used by companies.

The proposed rule, which is being studied by the Financial Accounting Standards Board, would force companies to list in financial reports the current market values of derivatives contracts that they buy to hedge, or offset, risk. The rule would also apply to derivatives used for trading or speculation, though few companies say they use derivatives for that reason. Many financial institutions oppose such a "mark to market" proposal, and the S&P move provides ammunition for their cause.

Derivatives are financial agreements whose returns are linked to, or derived from, the performance of underlying assets such as bonds, currencies or commodities. The FASB said it plans to issue its proposed rule for public comment in the third quarter.

Standard & Poor's, an important user and interpreter of financial statements for borrowers and investors, has rarely differed with the FASB publicly on major accounting questions but has instead commented privately to the board, which is the principal rule-making body for accounting. Standard & Poor's criticism, in addition to that by others, could influence the accounting standards board's discussion of the derivatives rule scheduled to resume today.

In a published commentary, the big credit-rating agency said that the FASB plan would cause greater volatility in the equity section of a company's balance sheet and "could distort a reporting entity's economic viability" through sharp changes in equity. The FASB's plan would require unrealized gains or losses of derivatives contracts used as a hedging device to be charged either against equity or earnings. Accountants say companies would almost certainly choose equity because the companies feel it looks less damaging to shareholders.

The plan the FASB is considering would bring unrealized losses or gains from current hedges using derivatives on to the balance sheet – a step that S&P opposes. S&P would instead favor improved footnote disclosures that remain off the balance sheet and don't affect equity or profit.

In an interview, Michael Serif, an S&P associate director, said that the FASB's plan to mark only the derivatives side of hedge to market while not doing the same to the underlying asset "would obscure" the transaction rather than disclose more about its underlying risks. The FASB and many accountants say it is difficult to mark to market assets such as bank loans whose interest-rate yields are hedged with swaps, which are derivatives.

Mr. Serif said the FASB approach would particularly hurt banks, financial institutions and brokerage houses that use swaps, options, futures and forwards – all derivatives – to hedge interest and exchange-rate changes. It may cause them "to avoid economically viable transactions out of fear that the reported financial condition of the company may look worse than it is," he added.

Mr. Serif said S&P decided to act when the FASB switched to a current-value approach on its derivatives-hedging project late last year. "We felt it was our duty to speak out on a FASB approach" that would confuse rather than enlighten financial-statement users on the dangers of using derivatives for hedging.

Robert Swieringa , a FASB member, said that S&P's criticism may hold true for fixed-rate financial instruments such as loans. But he added: "S&P is only looking at isolated transactions rather than all the hedging transactions that enterprises can do with derivatives." While some derivatives deals may start out as hedges, they become more speculative as the transaction changes, Mr. Swieringa said. "This isn't a simple subject. Any new accounting rule will involve tradeoffs" in disclosure improvement, he added.

Under current accounting rules, hedges used to protect commodity prices are marked to market while those used in financial transactions such as interest-rate swaps aren't. The difference is confusing many financial-statement users, say accountants. Donald Nicoliasen, a Price Waterhouse derivatives specialist, said that, "Many of our clients feel it's time for the FASB to get on with a rule on hedging that everyone understands."

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