FASB Modifies Derivatives Approach In a Move to Reduce Profit Fluctuations

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By LEE BERTON
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK – The Financial Accounting Standards Board modified a controversial approach to using derivatives as hedges that would have caused more volatility in profits.

But the FASB, the chief rule-making body for accountants, still set up some roadblocks to completely discarding this approach.

Businesses generally welcomed the new FASB approach because it will reduce the fluctuations in earnings that FASB's previous position would have created.

The FASB's new approach requires that all derivatives be valued at current market prices. But it permits using gains or losses in the value of underlying assets or liabilities to offset changes in the values of derivatives used in certain transactions. These transactions include hedges of foreign currency and transactions that hedge against interest-rate changes such as swapping fixed rate for floating-rate debt.

The FASB voted 5-to-2, the minimum vote for approval, to have its staff prepare a proposal to be issued in late June with a comment period of at least three months and possible public hearings. While there isn't any schedule for a final rule, it could be issued late this year or in early 1997, according to FASB staff members.

Retains Current-Value Approach

The new FASB proposal retains a current-value approach for all derivatives, including those used to hedge so-called "forecasted transactions." In such transactions, companies may buy inventory for future delivery at an unknown price. The proposal also doesn't permit hedging of intercompany transactions in which a parent company may hedge against a future dividend in a foreign currency to be received from an overseas subsidiary.

Hedging has been one of the most contentious areas in which the FASB has been working since it began its derivatives project four years ago. That's because companies depend upon derivatives to hedge against price changes in commodities, inventories and equipment and to protect themselves against future changes in interest rates or investment returns. Derivatives are financial instruments whose value is linked to underlying assets or liabilities.

For example, companies often use forwards and exchange-listed futures to protect against fluctuations in currency or commodity prices, thereby helping to manage import and raw-materials costs. And interest-rate options such as caps and floors help companies control financing costs in much the same way that caps on adjustable-rate mortgages do for homeowners.

Improve Financial Reporting

Dennis Beresford, chairman of the FASB, said the proposed rule "will improve financial reporting and eliminate some of the inconsistencies and incompleteness by recognizing derivatives as assets and liabilities on the balance sheet." Under current accounting rules, most derivative transactions aren't put on the balance sheet, he noted.

Mr. Beresford said that while the new proposal will make some derivatives users happy, "some will not be happy because they have a different view of economic reality than we at the FASB have."

Marjorie Marker, a senior manager with accountants **Arthur Andersen**, said that under the new FASB proposal, unless companies change the way they establish hedges with certain derivatives, they could encounter "higher borrowing costs and more volatility in earnings."

Philip Ameen, a vice president and comptroller of **General Electric** Co., Fairfield, Conn., said the FASB proposal is "a step in the right direction."

Companies generally are pleased that the latest FASB proposal doesn't force them to recognize in profits or equity the change in the value of the assets or liabilities being hedged in many cases. Thus if a derivative hedging the interest rate of a $1 million loan has a market value of $1 million but the loan is valued at $1.1 million, profits aren't increased by $100,000 as they would have been under a previous FASB approach.

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