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Cross-Border Derivative Accounting and Disclosure Requirements: Do The New Requirements Really Provide Useful Information to the Financial Statement Users?

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CROSS-BORDER DERIVATIVE ACCOUNTING AND DISCLOSURE REQUIREMENTS: DO THE NEW REQUIREMENTS REALLY PROVIDE USEFUL INFORMATION TO THE FINANCIAL STATEMENT USERS?

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I. INTRODUCTION

During the early 1990s, it was difficult not to pick up a newspaper or a magazine without reading about substantial financial losses due to derivative transactions. Orange County, California, filed bankruptcy after reporting losses of $1.5 billion;[1] Eastman Kodak reported losses of $220 million,[2] and Proctor & Gamble, $157 million.[3] The losses were not just reported in the United States, but throughout the global sector. Barings PLC of the United Kingdom reported a loss of $1.5 billion;[4] the German conglomerate, Metallgesellschaft AG, reported a loss of over $1.4 billion[5] and the Sumitomo Corporation of Japan forecast anticipated losses for 1996 derivative transactions to be approximately $2.6 billion.[6]

In the wake of these reports, regulators worldwide recognized that improvements were needed in the regulation, accounting, and disclosure requirements for derivatives.[7] The Securities & Exchange Commission ("SEC") urged the United States Financial Accounting Standards Board ("FASB") to get something done, if only temporarily, with regard to the accounting and disclosure issues surrounding derivative instruments.[8]

Although there are many issues relating to derivative use and trading, this Comment focuses on the changes in the accounting and disclosure requirements for derivative transactions. These changes resulted from the outcry of regulators around the world. In particular, this Comment analyzes the changes, if any, made in the United States, United Kingdom, and Japan, and the different methods suggested or adopted by different accounting standards boards. Recommendations made by the Basel Committee and the International Accounting Standards Committee are also reviewed. This Comment begins with a brief description of the major derivative instruments. Next, the growth and associated growing pains in the derivative market, the potential global financial risks faced by managers, and how derivatives assist in risk manage-

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1 *See* Debora Vrana, *Orange County in Bankruptcy*, LOS ANGELES TIMES, Dec. 9, 1994, at D1.

2 *See* Guy Halverson, *Derivatives Not a Big Risk for Most Fund Investors*, CHRISTIAN SCI. MONITOR., Mar. 10, 1995, at 8.

3 *See* Carol Loomis et al., *Untangling the Derivative Mess*, FORTUNE, Mar. 20, 1995, at 50.

4 *See The Collapse of Barings: A Fallen Star*, THE ECONOMIST, Mar. 4, 1995, at 19.

5 *See The Beauty in the Beast*, THE ECONOMIST, May 14, 1994, at 21.

6 *See Sumitomo Corporation Revises Unauthorized Copper Trading Losses*, UNIVERSAL NEWS SERVICE, Sept. 19, 1996, at 1.

7 *See* Financial Derivatives – Actions Needed to Protect the Financial System, GAO/GGD-94-133 (May 18, 1994) (hereinafter referred to as the "GAO Report 1994").

8 *See* John M. Foster, *Derivatives and Risk Management: The FASB Derivatives Activity and Disclosure*, 66 FORDHAM L. REV. 779, 782 (1997).

ment is discussed. The accounting and disclosure standards for derivatives is then reviewed, and the Comment concludes with a discussion of whether financial statement users are now getting the information needed to make informed investment decisions.

II. WHAT ARE DERIVATIVES?

The face of finance has changed with the emergence of new derivative instruments and the new ways that have been created to measure and manage the financial risk of an organization.[9] A risk adverse corporation "can avoid the chaos of the real world" by insulating itself from changes in interest rates, currency rates, and commodity and real estate price changes through the use of derivatives.[10] To meet the specific risk management objectives, derivatives provide an organization the opportunity to break its financial risk into smaller parts and then to buy and sell these parts accordingly.[11] To accomplish this, an enterprise will use a broker/dealer to purchase or write a derivative contract.[12] This allows the enterprise to keep those risks it feels comfortable managing and transfer its remaining risks to another party who is more willing to accept and manage the other risks.[13]

Barron's Dictionary of Financial and Investment Terms defines a derivative as "a contract whose value is based on the performance of an underlying financial asset, index, or other investment."[14] There are four types of basic derivatives: forward contracts, future contracts, options, and swaps.[15] Additionally, more complex derivatives can be built by combining any of these four basic types.[16]

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[9] *See* Henry T. C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985 (1995).

[10] *Id.* at 986.

[11] *See* Thomas F. Siems, *10 Misconceptions About Financial Derivatives*, USA TODAY, Mar. 1998, at 16.

[12] *See* Suzanne Bish, Note, *A Guide to Narrow the Derivatives' Understanding Gap and Reduce Losses: How to Increase Knowledge, Controls, and Reporting*, 58 OHIO ST. L.J. 539, 545-46 (1997).

[13] *See* Siems, *supra* note 11.

[14] BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 136 (4th ed. 1995).

[15] *See* CHARLES W. SMITHSON ET AL., MANAGING FINANCIAL RISK: A GUIDE TO DERIVATIVE PRODUCTS, FINANCIAL ENGINEERING, AND VALUE MAXIMIZATION 32 (1995).

[16] *See id.*

A. *Forward Contract*

The forward contract is considered to be the most straightforward and the oldest form of basic derivative.[17] The owner of a forward contract is obligated to buy a specific asset on a specified date at a price (exercise price) that was agreed to at the formation of the contract.[18] The owner will make a profit if, at maturity, the actual price is higher than the exercise price.[19] If the price of the asset is lower at maturity, the owner will take a loss.[20]

B. *Futures Contract*

Commodities futures have been traded since the 1860s on organized exchanges; however, financial futures are relatively new.[21] These instruments were introduced in the form of foreign currency futures in 1972.[22] The futures contract is like the forward contract in that it obligates its owner to purchase a specific asset at a specified contract price (spot price) on the maturity date of the contract.[23] The difference between a forward contract and a futures contract is that the futures contract is not intended to settle with delivery.[24] Forward contracts, on the other hand, should be held until the final settlement.[25]

C. *Swap Contracts*

Swap contracts are one of the latest innovations in financing.[26] They were publicly introduced in 1981.[27] The two parties of a swap contract are obligated to exchange, or swap, some specified cash flow at specified intervals.[28] An interest rate swap is the most common form of this instrument.[29]

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17 *See id.*
18 *See id.*
19 *See id.*
20 *See id.*
21 *See id.* at 33.
22 *See id.*
23 *See id.*
24 *See* THE HANDBOOK OF FIXED INCOME SECURITIES 1141 (Frank J. Fabozzi ed., 5th ed. 1997).
25 *See id.*
26 *See* SMITHSON, *supra* note 15, at 35.
27 *See id.*
28 *See id.*
29 *See id.*

D. *Option Contract*

In an option contract, the owner is given a right to either buy or sell an asset.[30] This is different from the owner of a forward, future, or swaps contract because in these contracts there is an obligation for the contract owner to buy, sell or swap.[31] There are two types of options - a call or a put. A call option gives the owner the right to buy an asset at a specified future date and price which is agreed upon today.[32] A put option contract gives the owner a right to sell an asset at a specified date and price. [33]

E. *What is an "Underlying" Asset or Index*

According to the definition of a derivative, the instrument derives its value from the performance of an underlying financial asset, index, or other investment.[34] The market movements of the underlying asset or index[35] cause the fair market value or cash flows of the derivative to fluctuate. Examples of an "underlying" asset or index include the LIBOR rate in an interest rate swap, the price of crude oil in a forward crude oil contract, or the spot exchange rate of a foreign currency in a foreign currency option.[36]

The size of the change in the "underlying" is based on the notional amount.[37] The notional is a fixed amount or quantity,[38] which typically does not change hands.[39] Examples of a notional include the stated principal amount in an interest rate swap, the stated number of wheat bushels in a wheat futures contract, or the contracted amount of French Francs in a foreign currency forward.[40]

"Derivatives are unique in that the parties do not have to initially invest or exchange the notional amount."[41] The derivative represents an investment in

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30 *See id.* at 37.

31 *See id.*

32 *See id.*

33 *See id.* at 35.

34 *See* BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS, *supra* note 14.

35 *See* ERNST & YOUNG, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES: AN EXECUTIVE OVERVIEW OF FASB STATEMENT 133, 4 (1999).

36 *See id.*

37 *See id.*

38 *See id.*

39 *See* FRANK J. FABOZZI & GIFFORD FONG, ADVANCED FIXED INCOME PORTFOLIO MANAGEMENT 233 (1994).

40 *See* ERNST & YOUNG, *supra* note 35.

41 *Id.*

the change of value in the underlying asset or index.[42] The following example shows how a derivative works in an interest rate swap. A fixed interest rate is swapped for a floating rate with a $10 million notional amount. No one party pays or receives the $10 million. It is the notional amount that is multiplied by the difference in the fixed and floating interest rates that determines how much cash is exchanged between the two parties.[43]

II. GROWTH AND THE ASSOCIATED GROWING PAINS IN THE DERIVATIVE MARKET, AND HOW DERIVATIVES CAN HELP MANAGERS REDUCE THE POTENTIAL GLOBAL RISK

Derivative instruments are popular with all types of users - insurance companies, manufacturers, banks, not-for-profit agencies, governments,[44] mutual funds, pension funds and commercial firms worldwide.[45] For year ending 1992, the outstanding notional amount worldwide was $12.1 trillion.[46] In 1997, this amount was estimated to be $70 trillion.[47] Derivatives are globally used and have evolved to meet the demand for cost-effective protection against risks associated with market rates and price movements.[48] The increased use of derivatives is a result of the changes that have taken place in the risk environment in which businesses operate.[49] These changes include the relaxation of trade and capital restrictions, and the development of complex, cross-boundary economic relationships.[50] The world market is no longer dominated and stabilized by the United States or other economic

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[42] *See id.*

[43] *See id.*

[44] *See* Roger H.D. Molvar & James F. Green, *The Question of Derivatives*, J. ACCT., Mar. 1, 1995, at 2.

[45] *See Securities Derivatives Rules, March 4, 1997: Before Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. (1997) (statement of Joseph P. Bauman, Senior Vice President and Global Dir. Bank of America) (hereinafter "*Securities Derivatives Rules*").

[46] *See* GAO Report 1994, *supra* note 7, at 25.

[47] *See Oversight Hearing on GAO Financial Derivatives Report, May 19, 1994: Before Subcomm. on Telecomm. and Fin. of the House Comm. of Energy/Telecomm. and Fin.*, 103rd Cong. (1994) (statement of Edward J. Markey, D-MA, Chairman of the House Subcomm. on Telecomm. and Fin.) (hereinafter "*Oversight Hearing on GAO Report*).

[48] *See* GAO Report 1994, *supra* note 7, at 23-24. In determining the use of derivatives internationally, the GAO interviewed officials from banks and security regulation offices; stocks, future and option exchanges; and foreign financial institutions from Australia, France, Germany, Japan, Singapore, Switzerland, and the United Kingdom. The GAO also interviewed officials from BIS, Basle, EC, IOSCO, OECD, World Bank and ISDA.

[49] *See* Charles P. Baril et al., *Managing Risk With Derivatives*, MGMT. ACCT., Nov. 1996, at 20.

[50] *See id.* at 21.

powers.[51] The U.S. government has dropped most attempts to fix interest rates, exchange rates, and the price of goods and services.[52] Also, advances in information and computer technology have enabled the design and use of more complex financial instruments.[53]

There are two types of risk facing business managers - business risk and financial risk. Business risk relates to the uncertainties connected with developing, manufacturing and marketing products and services.[54] Financial risk is the uncertainty associated with exposure to fluctuating interest rates, currency exchange rates, and the price of commodities and equities.[55]

With the rapidly changing global business environment, managers often have an incomplete understanding of the financial risks they face.[56] Managers usually feel confident in projecting raw material usage, but few feel comfortable projecting the future currency exchange rates.[57] Here, they lose the competitive advantage, but managers also realize that the choice of doing nothing, hoping for the best, and letting external events shape their financial results can be devastating.[58]

One choice a manger has is to hedge the company's risk with the use of derivatives. Hedging the company's risk is just good business management,[59] and one choice a manger has is to hedge the company's risk with the use of derivatives. The proper use of derivatives can be an important tool to protect a business from these risks.[60] Derivatives allow a business to counterbalance existing risk associated with exposure to fluctuations in interest rates, currency exchange rates, and equity and commodity prices.[61] The result of successful

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51 *See* SMITHSON, *supra* note 15, at 3. In 1944, the financial leaders met and agreed to the Bretton Woods standard which set a fixed exchange rate system based on a ratio of the U.S. dollar to gold. Importers knew what they would pay for goods in their domestic currency. In 1971, the Bretton Woods system was no longer used and replaced with a floating exchange rate system. Both sides of the transaction now face exchange rate risk.

52 *See id.*

53 *See* Hu, *supra* note 9, at 990. Financial scientists have been hired to develop new products, relying on computers and an "array of esoteric models laden with incomprehensive Greek letters." As more exotic financial products are created, risks and uncertainties increase.

54 *See* Baril, *supra* note 49, at 20.

55 *See id.*

56 *See id.*

57 *See id.*; *see also* SMITHSON, *supra* note 15, at 65. In the past, management could shrug off financial price risk and blame poor results on the "movement of the dollar or unforeseen interest rate changes" because it was thought that management of the firm could not do anything about the financial price changes.

58 *See* Baril, *supra* note 49.

59 *See* SMITHSON, *supra* note 15, at 65.

60 *See id.* at 72.

61 *See* Baril, *supra* note 49, at 20.

derivative use is a limiting of potential losses and stabilization of cash flows with speed, precision, flexibility, and low transaction costs.[62] Contrarily, improper use of derivatives can cause substantial harm to a company's financial position.[63]

The effectiveness of derivatives for a particular purpose often depends on many factors.[64] As mentioned before, derivatives can be used to manage risk associated with transactions. This is called hedging.[65] However, derivatives also provide opportunities to profit on anticipated changes in market prices and interest rates.[66] This is called speculating.[67] "What is new with derivatives and gives rise to concern is the proliferation of increasingly exotic, customized over the counter derivatives that enable users to make synthetic side bets on the global market."[68]

With the growth and increasing complexity of derivative instrument use, "Congress, federal regulators, and some members of the industry are concerned about the risk derivatives may pose to the financial system, individual firms, investors, and US taxpayers."[69] There must be assurance that there are "appropriate customer protections in place in the form of full disclosure, accurate financial accounting and appropriate sales practices."[70] An economy that functions effectively depends "upon financial information that is widely used, reliable, and clearly understood."[71] Based on the public disclosures available to the senior officials at either Procter & Gamble or Metallgesellschatt, it is unclear whether they were fully informed of their companies' financial risk due to its derivative exposure.[72]

The accountability for controlling risk rests with the Board of Directors and senior management.[73] Auditors also play an important role in testing for compliance with the risk management policies and controls.[74] Strong corporate governance includes the following: (1) competent supervision by the Board of Directors and senior management to ensure that the risk management system

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62 *See id.*

63 *See id.*

64 *See* Molvar & Green, *supra* note 44.

65 *See Financial Derivatives – Actions Needed to Protect the Financial System, May 19, 1994: Before House Comm. of Energy/Telecomm. and Fin.*, 103rd Cong. (1994) (statement of Charles A. Bowsher, Comptroller General of the United States) (hereinafter "*Financial Derivatives*").

66 *See id.*

67 *See id.*

68 *Oversight Hearing on GAO Report, supra* note 47.

69 *Financial Derivatives, supra* note 65.

70 *Oversight Hearing on GAO Report, supra* note 47.

71 GAO Report 1994, *supra* note 7, at 67.

72 *See* Baril, *supra* note 49, at 20.

73 *See* GAO Report 1994, *supra* note 7, at 34.

74 *See id.*

is in place and functioning as anticipated; and (2) the audit committee providing supervision of the internal and external auditor activity to ensure that proper attention is placed on the internal controls and to provide assurances that management is not overriding them.[75] In addition, an effective risk management system must be flexible to respond to any volatility in the financial markets and the resulting rapid and unanticipated changes in the value of the company's portfolio.[76] "Without a clearly defined risk management strategy, use of financial derivatives can be dangerous" and threaten the firms' long-range objectives.[77] Speculative and unsound derivative practices could eventually lead to insolvency.[78]

The effect of losses resulting from a weak and ineffective risk management system may be felt worldwide. Derivatives are now used by thousands of corporations.[79] A small number of these firms are the derivative dealers - the big commercial banks and major securities firms.[80] For these few corporations, derivatives have been a substantial source of profits.[81] The remaining derivative users include the smaller banks, pension funds, governmental units, corporations, insurance companies and mutual funds.[82] These users are the counter-parties to the contracts who use derivatives to hedge some risk they do not want to bear themselves.[83] The result is a "tightly wound" market of many global interconnections that have never existed before.[84]

The linkage between the major U.S. dealers and foreign dealers is substantial.[85] Fourteen of the major over-the-counter dealers reported that the transactions they have with foreign dealers represent about 24% of the combined derivative global notional amount.[86] Linkages in the financial markets allow firms in one market to hedge against risk arising from the firm's participation in another market.[87] The linkages among the institutions have

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75 *See id.*

76 *See id.*

77 Robyn Meredith, *Ten Misconceptions about Financial Derivatives*, USA TODAY, Apr. 28, 1999, at 1B.

78 *See id.*

79 *See* Carol J. Loomis, *The Risk that Won't Go Away*, FORTUNE, Mar. 7, 1994, at 40.

80 *See id.*

81 *See id.*; *see also* Hu, *supra* note 9, at 988 ("[T]he majority of Bankers Trust earnings came from helping clients manage the financial risks and from the financial trading and positioning of securities, derivative, and other assets in its own accounts.").

82 *See* Loomis, *supra* note 79, at 40.

83 *See id.* at 41.

84 *Id.*

85 *See Financial Derivatives*, *supra* note 65.

86 *See id.*

87 *See* GAO Report 1994, *supra* note 7, at 29.

expanded.[88] The Group of Thirty (G-30) reported in 1993, that "international finance and commerce have become increasingly integrated and that the use of derivatives has followed this evolution."[89]

Unfortunately, as a result of the combination of global involvement, concentration, and linkages, the withdrawal by any one of the large U.S. dealers in trading could "cause liquidity problems in the markets."[90] This same sudden withdrawal could also create a financial risk to others, including federally insured banks and the financial system as a whole.[91] A past financial crisis shows how there is a direct link between the markets and institutions. Regarding the stock market crash of 1987, a former president of the New York Federal Reserve Bank said in a 1992 letter to Congress, "the market for equities and associated derivatives effectively function as one market."[92] Studies conducted on the October 1987 market crash revealed that a disruption in one market was related to the disruption in another market due to the interrelation in prices in the stock, futures and options markets.[93] The turmoil in the European currency market in 1992 also was the result of the link between derivatives and the underlying markets.[94] Some of the over-the-counter trading was suspended due to the volatility in the cash markets.[95] As a result of this suspension, there was a spurt of trading activity in the exchange-traded derivatives.[96]

Although there are substantial cross-border derivative transactions, the regulation of derivatives varies across the countries and significant gaps and weaknesses exist.[97] Within the United States itself, there are gaps in the

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[88] *See id.*

[89] *Id.* G-30 or Group of Thirty is composed of 30 high level individuals drawn from central banks, commercial bank management, the economics' profession and finance ministries in both developed and developing countries.

[90] *See Financial Derivatives*, *supra* note 65.

[91] *See id.*

[92] GAO Report 1994, *supra* note 7, at 29; *see also* SMITHSON, *supra* note 15, at 55. Equity index derivatives were used prior to 1987 as portfolio insurance to protect investors in market price changes. However, the "dynamic hedging" strategies that called for the large numbers of sale or purchase contracts in response to the market price changes in October 1987 failed to function as expected. The derivative markets sudden loss of liquidity made the large trades of the "insurance programs" impossible to execute. *Id.*

[93] *See* GAO Report 1994, *supra* note 7, at 29

[94] *See id.*; *see also* ALLEN SHAPIRO, MULTINATIONAL FINANCIAL MANAGEMENT 92, (1996). To battle inflation, Bundesbank increased the German interest rates to tighten the monetary policy. Other members of the EMS were pressured to increase their interest rates to defend themselves against the currency parities and also to halt the speculative attacks on their currencies. *Id.*

[95] *See* GAO Report 1994, *supra* note 7, at 29.

[96] *See id.*

[97] *See Financial Derivatives*, *supra* note 65.

regulations among the various industries that use derivatives.[98] "Banking, securities, and insurance are no longer separate and distinct industries that can be well regulated by the existing patchwork quilt of Federal and State agencies."[99] For example, securities regulators have limited authority over the financial activities of a securities firm's affiliate that conducts over-the-counter derivative activity.[100] Insurance companies' over-the-counter affiliates are subject to limited state regulation and no federal regulation.[101] Yet over-the-counter affiliates of securities and insurance firms make up a rapidly growing part of the derivatives market.[102] In contrast, "bank regulators have authority to regulate all the financial activities of banks and their holding companies."[103]

The problem of inconsistent regulations is exacerbated by the inadequate rules for financial reporting which contributes to the lack of knowledge that investors, creditors and other market participants require in analyzing an enterprise's potential financial risk from its derivative use.[104] In foreign markets, the individual country's regulators and accounting bodies specify the extent of derivative disclosures in public financial statements.[105] Although disclosure is greater in some foreign markets, regulators and financial institution officials from several countries have said that the existing requirements generally do not allow for accurate assessment of a company's financial condition.[106]

Regulators must "have the tools they need to minimize the potential for derivatives to contribute to a major disruption to the financial markets, either through excessive speculation and over-leveraging, or due to inadequate internal controls and risk management."[107] To reduce the risk of systemic disruption, the regulators of several countries agreed that the minimization of disruption due to derivatives would require regulators, market participants and others to ask jointly for improved derivative risk management, accounting, and disclosure practices.[108]

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98 *See id.*

99 *Id.*

100 *See id.*

101 *See id.*

102 *See id.*

103 *Id.*

104 *See id.*

105 *See* GAO Report 1994, *supra* note 7, at 84.

106 *See id.*

107 *See Oversight Hearing on GAO Report, supra* note 47.

108 *See* GAO Report 1994, *supra* note 7, at 78.

IV. THE GLOBAL RESPONSE OF ACCOUNTING BOARDS TO THE INCOMPLETE AND INCONSISTENT DISCLOSURES AND THE LACK OF REPORTING OF DERIVATIVE ACTIVITIES

Investors, creditors, and others use financial statements to evaluate management's performance and measure the firms borrowing power.[109] Investors use financial statement information as a guide for their investment decisions.[110] Therefore, the same reasons for rules for other financial activities can be applied to derivative accounting.[111] Accounting rules provide financial statement users assurance that the information is consistent and reliable.[112] Sufficient information to assess the enterprise's overall market risk exposure, whether using derivatives or not, is crucial to investors to enable them to perform high quality and correct financial analysis.[113]

The ability for investors to compare companies is dependent on information about risk management and accounting policies.[114] With this information an investor will be able to understand why the same risk exposure in one company has a different strategy or objective in another company when managing the same risk.[115] Accounting policy disclosures provide the necessary information so investors can determine why the same derivative instrument used to hedge the same asset or liability at one company is accounted for differently at another company.[116] Analysts then are able to adjust reported earnings accordingly by taking the different accounting treatments into effect.[117]

Regarding derivatives the accounting standards have been incomplete and inconsistent.[118] "Disclosure [was] abysmal in the U.S. annual reports and virtually non-existent in countries like Japan and Germany."[119] The standards

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109 *See id.* at 67.

110 *See id.*

111 *See id.*

112 *See id.* at 22.

113 *See Oversight Hearing on Proposals by the U.S. Securities & Exchange Comm'n and the Fin. Accounting Standards Bd. Affecting the Accounting Treatment of Financial Derivatives, March 4, 1997: Before Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. (1997) (statement of William P. Miller, Independent Rick Oversight Officer, The Common Fund. Statement for the Assoc. for Inv. Management and Research (AIMR)) (hereinafter "*Oversight Hearing on Proposals*").

114 *See Oversight Hearing on Proposals*, *supra* note 113.

115 *See id.*

116 *See id.*

117 *See id.*

118 *See Financial Derivatives*, *supra* note 65.

119 Loomis, *supra* note 79.

have not kept pace with business practices.[120] Insufficient accounting rules and disclosures increase the likelihood that financial reports will not fairly represent the substance and risk of derivative activities.[121] Lack of rules for certain products make it very possible that financial reports will be inconsistent resulting in the reduction of comparability among financial reports.[122]

A. *Response by the United States Financial Accounting Standards Board*

In 1994, the SEC reviewed 500 annual reports.[123] This review found many problem areas. First, the required footnote disclosures were too vague to communicate the differences in the accounting for derivatives.[124] Second, the associated effects of derivatives were not disclosed in the footnotes.[125] Third, derivative and other financial instrument disclosures were made in segregation of other items so the net exposure of the companies' market risk was not communicated to the financial statement user.[126] Additionally, it is believed that some of the financial statement users could not determine from these disclosures what financial instruments the companies were using, how these instruments were accounted for, and what risks the company had transferred or accepted.[127] The Committee found that the investors' need for accounting standards that require appropriate recognition and measurement of market risk sensitive investments, and adequate supplemental disclosures so the investors can have a thorough understanding of an enterprise's use of these instruments could not be overemphasized.[128]

With the previous standards, investors and other financial statement users may have been misled by a company's financial reports because the information regarding derivative use may have been inconsistently presented and did not reflect the significance and risks of the derivative activity.[129] Investors and creditors were mystified and frustrated about the effects of derivatives.[130] Investors have been caught off guard, on more than one occasion, by large

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120 *See Financial Derivatives*, *supra* note 65.

121 *See id.*

122 *See id.*

123 ERNST & YOUNG, LLP, THE SEC'S MARKET RISK DISCLOSURE RULES AND DERIVATIVE ACCOUNTING POLICY DISCLOSURE REQUIREMENTS, at 10 (1997).

124 *See id.*

125 *See id.*

126 *See id.*

127 *See id.*

128 *See Oversight Hearing on Proposals*, *supra* note 113.

129 *See* GAO Report 1994, *supra* note 7.

130 *See* Foster, *supra* note 8, at 783.

unexpected losses reported by companies that accounted for derivatives using their historical cost, or by not accounting for the derivatives at all.[131] Transparency of derivative positions would certainly demystify these effects.[132]

From the basic financial statement information, investors could not ascertain the potential for gains and losses that may have been realized when the derivative instrument settled.[133] Investors must know how a company accounts for unrealized gains or losses to determine what other financial statement items will be affected by the transaction.[134] To understand the reported results of a company, it is essential that the investors have detailed and meaningful disclosures of the accounting methods used.[135] These were issued that needed to be resolved.

After several years of deliberation and exploration of all possible alternatives had passed, the U.S. Financial Accounting Standards Board (FASB) issued Financial Accounting Statement 133 (FAS 133) *Accounting for Derivative Instruments and Hedging Activities.*[136] FAS 133 demonstrated a compromise by the FASB.[137] The FASB had difficulty keeping up with the ever-changing global financial markets and the new financial instruments used by companies to manage or hedge their market risk exposure.[138] FAS 133 applied to all derivative instruments, including those that have not yet been developed.[139]

Prior to FAS 133, rules governing the accounting treatment for derivatives in the United States had not adequately covered some of the most basic types of derivative products.[140] Past derivative accounting had been determined by objectives of the companies using the derivatives.[141] For profit or speculating, changes in the market value were reflected as a gain or loss.[142] For hedging, changes were reflected in the balance sheet as the underlyings.[143]

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131 *See id.* at 779.

132 *See id.* at 783.

133 *See id.* at 779.

134 *See Oversight Hearing on Proposals, supra* note 113.

135 *See id.*

136 Arlette C. Wilson et al., *The Decision on Derivatives: FASB Statement No. 133 Establishes Comprehensive Accounting Requirements*, J. ACCT., Nov. 1998, at 24.

137 *See id.*

138 *See id.*

139 *See id.*

140 *See* GAO Report 1994, *supra* note 7, at 66.

141 *See id.* at 67.

142 *See id.* at 68.

143 *See id.*

The FASB undertook the project of FAS 133 primarily because of the lack of transparency of the derivatives in the basic financial statements, which had the consequential effect of incomplete and inconsistent accounting methods.[144] Making derivatives visible and reported on the balance sheet was one of the FASB's top priorities,[145] along with the notion of derivative risk reduction.[146] Many of the risks of derivatives were reported off-balance sheet and there was also inadequate disclosure about them.[147] The FASB was looking for the "perfect Holy Grail."[148] That perfect solution will not be found until all financial instruments are reported at fair value.[149] FAS 133 requires that derivative instruments be put on the balance sheet at fair value.[150] However, some financial instruments are still reported at historical cost.

The FASB derivative project has not been without controversy.[151] The project took six years to complete, was discussed at over 100 FASB meetings, went through the comment process twice, was subject to two separate congressional hearings, and legislation was proposed to override the statement (the proposed legislation is no longer being pursued).[152] After the years of controversy, FAS 133 was issued in June 1998, and is required to be adopted for fiscal years beginning after June 15, 2000.[153]

FAS 133 represents major changes in hedge accounting,[154] and can be intimidating both in breadth and complexity.[155] Many entities will have to reclassify some of their financial instruments that were previously not thought of as derivatives to derivative instruments due to the broad definitions of FAS 133.[156] By requiring all of the instruments defined as derivatives to be reported as assets or liabilities, visibility, comparability and understanding of the risk involved in the entities' holding of derivatives should increase.[157] Deferred gains and losses no longer are reported as liabilities or assets, respectively, which should improve comprehensibility.[158] The basic underlying premises of the new approach are: (1) "derivatives represent rights or obligations that

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144 *See* Foster, *supra* note 8, at 779.

145 *See id.* at 782.

146 *See Securities Derivatives Rules*, *supra* note 45.

147 *See* Foster, *supra* note 8, at 783.

148 *Id.* at 782.

149 *See id.*

150 *See id.*

151 *See* ERNST & YOUNG, *supra* note 35, at 1.

152 *See id.*

153 *See id.*

154 *See* Wilson, *supra* note 136, at 24.

155 *See* ERNST & YOUNG, *supra* note 35, at 1.

156 *See id.*

157 *See* Wilson, *supra* note 136, at 24.

158 *See id.*

meet definitions of asset (future cash inflows from another party) or liabilities (future cash outflows) and should be reported as such in the financial statements," (2) "fair value is the most relevant measure for financial instruments and the only measure for derivatives," (3) only items that are assets and liabilities should be reported on the balance sheet, and (4) "special accounting for items designated as being hedged should be provided only for qualifying transactions," which would include an assessment of the expectation of the hedge.[159] Transactions that qualify for special accounting do not have to report the changes in fair value of the derivative reflected on the balance sheet in current income as required for non-qualifying derivative transactions.[160] As a result of the reclassifications and reported changes many companies' balance sheets may increase in size.[161]

Derivatives generally reflect a mutual exchange of promises with no exchange of tangible consideration. Because there was no initial investment, the derivative would have been reported off-balance sheet, invisible to the financial statement users and concealing the risk.[162] However, because a derivative can settle at a gain with the company receiving cash, or at a loss with the company having to pay cash, the company does have a right or obligation.[163] Requiring the fair value of the derivative to be reported on the balance sheet ensures visibility on the financial statements.[164]

FAS 133 will also reduce the inconsistency, incompleteness, and complexity of previous guidance and practice by providing comprehensive rules for all derivative and hedging activities--both for current derivative instruments and those yet to be developed.[165] The guidance that existed previously could have been conflicting, yet that may have been the only guidance that the entity had to rely on. Alternatively, if the entity felt the guidance did not apply they created their own accounting methods.[166] By creating their own accounting methods, the information in the financial statements was inconsistent and resulted in inadequate information.[167]

As one could imagine, there were "squeals" from the financial services industry about FAS 133 when it was first proposed, but the FASB was "sticking to its guns" that most derivatives be required to be disclosed and all

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159 ERNST & YOUNG, supra note 35, at 1.

160 *See id.* at 8.

161 *See* Wilson, *supra* note 136, at 24.

162 *See id.*

163 *See id.*

164 *See id.*

165 *See id.*

166 *See id.*

167 *See id.*

gains and losses pass through income.[168] Senator Faircloth introduced a bill that would exempt banks and Representative Baker introduced a bill to return standard setting to the federal government.[169] More than twenty top U.S. business leaders signed a strongly worded letter to the FASB stating that the new rules would cause a "weakening of companies' ability to manage risk."[170] The constituent concern was that they would not be able to manage risk in a way they would like.[171] Management would like to select the level of risk they want to take and alter it depending on their views of the market (some call this speculating).[172]

During a U.S. Senate Committee Hearing, Mr. Bauman testified that that there was a "workable, well-understood framework already in place,"[173] therefore a change in the accounting standard was not necessary. Mr. Bauman was referring to a study done by KPMG Peat Marwick.[174] According to KPMG, 90% of the 139 financial and non-financial corporations "surveyed match the accounting of swaps with the economics of the underlying transaction."[175] And 99% of the companies surveyed said, "they require that derivative instruments be designated and documented as relating to a particular risk management strategy."[176] However, what Mr. Bauman's testimony did not reveal is whether any of this information is disclosed to make the derivative activity more visible to the investor.[177] In the end the FASB changed the exposure draft and abandoned any notion that risk must be reduced at all in order for a derivative to receive special accounting.[178]

When the FASB started this project, it was designed to address hedge accounting on a broad basis.[179] Subsequently, the focus changed to accounting for derivatives because most hedging is done with derivatives.[180] Hedge accounting was based on an exception and thought of as special.[181] The

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168 *Debate on New U.S. Accounting Standards for Derivatives*, FIN. TIMES, Mar. 19, 1998, at 34.

169 *See id.*

170 Tracy Corrigan, *Business Leaders Attack Derivatives Rules*, FIN. TIMES (LONDON), Aug. 1, 1997, at 25.

171 *See* Foster, *supra* note 8, at 781.

172 *See id.*

173 *See Securities Derivatives Rules*, *supra* note 45.

174 *See id.*

175 *Id.*

176 *Id.*

177 *See id.*

178 *See* Foster, *supra* note 8, at 781-82.

179 *See id.* at 779.

180 *See id.*

181 *See id.*

problem here was that in order to have an exception, the normal accounting must be known, and it was not known.[182]

Demand for special accounting for hedges arose from two types of anomalies: (1) recognition and (2) measurement. Recognition anomalies arise because some assets and liabilities are in the balance sheet, while others are not.[183] Measurement anomalies arise when existing accounting standards use different attributes to measure different assets and liabilities - historical cost, current prices, or a combination of historical cost and current prices, or the lower of cost or market value.[184] Now that the FASB has defined what qualifies as a hedge, it has also been able to design an exception - "special accounting" - which is a different accounting treatment than that required for other derivatives.

FAS 133 requires the changes in the fair values of derivatives to be reported in income,[185] except the FASB allows "special accounting" for the three categories of hedges. First, fair value hedges – the change in the fair value of the derivative and the hedged item attributable to the risk is recognized in earnings.[186] To the extent of the effectiveness of the hedge, the change in the fair value of the hedged item will be offset in income with little or no effect to earnings.[187] Second, cash flow hedge – to the extent of the effectiveness of the hedge, the change in the fair value of the derivative is recognized in other comprehensive income in shareholders' equity until the forecasted amount affects income.[188] At that time, the amounts previously recognized in other comprehensive income are reclassified to income.[189] Third, foreign currency hedge – to the extent of the hedge effectiveness, the change in the fair value of the derivative is treated as a translation gain or loss and recognized in other comprehensive income offsetting other translations gains or losses arising in consolidation.[190]

If the derivative is highly effective but does not perfectly offset the changes in the hedged item, the "ineffective portion must be recognized in income at the same time the change in the fair value of the derivative is recognized on the balance sheet."[191]

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182 *See id.* at 779-80.

183 *See id.*

184 *See id.*

185 *See* ERNST & YOUNG, *supra* note 35, at 8.

186 *See id.* at 9.

187 *See id.*

188 *See id.*

189 *See id.*

190 *See id.*

191 *Id.*

As mentioned earlier, the final statement is a compromise, which is imperfect and will not satisfy everyone.[192] The FASB originally wanted a test to ensure that the enterprise as a whole has reduced risk through hedging.[193] But the FASB concluded that a test to show risk through hedging as a whole was impossible to design because strategies for cash flow and market value hedging are incompatible.[194] The FASB ultimately settled on an approach that permits "special accounting" for some hedges, as long as it appears that risk is being reduced on a transaction-by-transaction basis.[195] The "special accounting" is permitted even in the case where the total risk of the company in fact has increased.[196]

There is also a concern that the fair value valuation would significantly increase the volatility of the earnings and capital reported in the financial statements, discouraging the use of cost-effective risk management.[197] The partial and imperfect hedges would require an entity to include some of the changes in the derivatives' fair values in the current earnings.[198] Also, there may be volatility in equity because an entity would have to report any unrealized gains or losses from derivatives designed as cash flow hedges in other comprehensive income.[199] The accumulated gain or loss would no longer be deferred but included in earnings in the same period as the earning impact from the change in the fair value of the hedged item.[200] The more the fair value of the derivatives fluctuates, the more volatile the comprehensive income and equity becomes.[201]

It has been predicted, though, that the ability to defer gains and losses on derivatives will diminish rather than increase.[202] As the FASB continues work on financial instruments and measuring and reporting liabilities at fair value, many anomalies that require special accounting for hedges today will be eliminated.[203]

FAS 133 also included new disclosure requirements based on the type of hedge.[204] The disclosures are the responsibility of the entities' board of

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192 *See* Foster, *supra* note 8, at 783.

193 *See id.* at 781.

194 *See id.*

195 *See id.*

196 *See id.*

197 *See Securities Derivatives Rules*, *supra* note 45.

198 *See* Wilson, *supra* note 136.

199 *See id.*

200 *See id.*

201 *See id.*

202 *See* Foster, *supra* note 8.

203 *See id.*

204 *See id.* at 779-80.

directors and management.[205] Independent auditors do not complete an attestation of the disclosures.[206] Generally, the disclosure requirements of FAS 133 are as follows:

1. The Entity must disclose its objectives and strategies for holding or issuing the derivative.
2. The disclosure must include a description of the risk management policy for each type of hedge, including a description of the items or transactions for which the risk is hedged.
3. The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedge effectiveness and (b) the component of the derivative (the gain or loss, if any, is excluded from the assessment of the hedge effectiveness) and a description of where the net gain or loss is reported in the income statement.[207]

The disclosures apply to all hedging activity and they must be segregated between the three types of hedges - Cash Flow, Fair Value, and Foreign Currency hedges.[208]

B. *Response by the United Kingdom's Accounting Standards Board*

The United Kingdom's Accounting Standards Board (ASB), the British financial reporting body, has been criticized for not producing guidance on accounting for derivatives.[209] This "black hole" (risks which do not appear in the financial statements) has concerned regulators for the past several years.[210] "The complexity and secrecy of these transactions [were] seen as a breeding ground for fraud."[211] However, listed companies in the United Kingdom will now have to disclose their financial risk exposure from derivative use in their annual report.[212]

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[205] *See* James L. Craig, Jr., *Regulating Derivatives to Protect the Public; Interview with General Accounting Officer Chief Accounting Donald H. Chapin*, CPA JOURNAL OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS, Oct. 1995, at 40.

[206] *See id.*

[207] ERNST & YOUNG, *supra* note 35.

[208] *See id.*

[209] *See* Jim Kelly, *Lack of Derivatives Rule Rapped*, FIN. TIMES (LONDON), May 8, 1995, at 6.

[210] *Plugging the Black Hole: Investors Are Often Exposed to Risks that Do Not Appear in Account At All, Until Now*, FIN. TIMES (LONDON), Sept. 24, 1998, at 32.

[211] Jim Kelly, *Tougher Accounting Code on Derivatives*, FIN. TIMES (LONDON), Apr. 24, 1997, at 13.

[212] *See id.*

The first step taken by the ASB in the controversial project of derivative accounting and disclosure requirements was to require companies to disclose their derivative and financial instruments at market value.[213] They are also required to show any changes of the value of these instruments in the current reporting period.[214] In comparison to the United States, the United Kingdom decided to take smaller steps first and solely tackle disclosure.[215] An actual accounting standard will probably not "see the light of day before 2001."[216]

Company Reporting, the monthly monitor of annual reports, said several companies like Unilever and British Petroleum have already increased their disclosure.[217] "This year's improvements indicate the higher priority companies place on derivative disclosure. If the ASB is to make an impact, the board should ensure that its standards reflect the priorities of the companies."[218]

The new standard is designed to focus on the disclosure of significant risks.[219] Companies would have to discuss their risk exposure and risk management strategies in the financial statements.[220] The notes would include an explanation of the estimated value at risk, an indicator to investors of possible disturbances to the assets and liabilities if changes in the external economic environment occurred.[221] Also the risk strategy will be clearly laid out.[222] The ASB believes that companies will change the way they manage risk if the risk management strategy is audited and included in a "clearly laid out" narrative of the financial report.[223]

Investors now will have a clear picture of the use of financial instruments and the extent to which they are used to hedge risk or are traded speculatively.[224] The new rule became effective for companies reporting on or before March 23, 1999.[225] In response to criticism of the new requirement, Allen Cook, Technical Director of the ASB said, "The question to a user of

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213 *See id.*

214 *See id.*

215 *See Plugging the Black Hole*, *supra* note 210.

216 *Id.*

217 *See* Kelly, *Lack of Derivatives*, *supra* note 209.

218 *Id.* (quoting the Company Reporter).

219 *See* Kelly, *Tougher Accounting Code*, *supra* note 211.

220 *See id.*

221 *See Plugging the Black Hole*, *supra* note 210.

222 *See id.*

223 *Id.*

224 *See id.*

225 *See* ASB Standards in Issue – FRS 13, *Derivatives and Other Financial Instruments (Issued Sept. 1998) at* http://www.asb.org.uk/publications/publication146.html (visited Mar. 17, 2000).

these accounts is: 'Could you do without this information - just ask yourself.' The answer has to be 'No!'"[226]

C. *Response by Japan's Ministry of Finance*

In Japan, a company's assets were required to be valued at cost or the lower of cost or market.[227] The market value (fair value) method of accounting was not permitted.[228] Non-financial companies were required to disclose information only on a small portion of derivative instruments - futures, options, and currency forward transactions.[229] In contrast, the new standards encompass all derivatives including swaps, which account for the majority of derivative trading.[230] The use of the market value is now required for derivatives because the Ministry of Finance believed this was the only way to properly and accurately show the derivative and trading results.[231]

Under the prior system, only realized gains and losses were reported in the balance sheet.[232] By delaying settlement of financial instruments with latent losses it was possible for the financial condition of the reporting company to appear better than the actual condition.[233] The disclosures had limited information on futures, options, and forward exchange contracts with no audit requirement.[234] The Ministry of Finance amended the standard and introduced the following disclosure requirements:

1. All types of derivatives traded over the counter and on authorized exchanges will be stated as a note in the securities report to be disclosed to the public;
2. In addition to the volume of the derivative trading, the disclosure must include the contents, trading policy, purpose, risk and risk management of each derivative transaction;

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226 *See Plugging the Black Hole*, *supra* note 210.

227 *See* Makoto Shimada, *Japan-New Accounting and Disclosure Requirements for Derivative Transactions*, BUTTERWORTHS J. OF INT'L BANKING AND FIN. LAW, Sept. 1997, at 392.

228 *See id.*

229 *See Tighter Disclosure Standards Eyed for Derivative Deals*, JAPAN ECONOMIC NEWSWIRE, Feb. 23, 1996.

230 *See id.*

231 *See* Shimada, *supra* note 227.

232 *See MOF to Set New Accounting System for Derivatives Deals*, JAPAN ECONOMIC NEWSWIRE, Feb. 3, 1996.

233 *See id.*

234 *See* Shimada, *supra* note 227, at 392.

3. The volume of each transaction must be disclosed along with the contract amount or expected principal amount, and the market value and basis used to calculate the market value; and
4. An external-auditing firm must audit the above disclosures.[235]

The new standards will provide investors with information to assess the investment risk.[236] The new standards will also help companies strengthen its check functions over internal risk.[237] Companies will now be required to report the details of the derivative transactions including the purposes for the derivative use and risks associated, as well as the value of the over-the-counter deals.[238] Gains and losses will be based on the market value of the securities held by the corporation and will be disclosed at the end of each business period.[239] Investors will be able to avoid risk because they will now have accurate information in that the corporate business reports which will now show the latent gains and losses incurred from derivative activity.[240]

D. *The International Accounting Standard Committee's (IASC) Comprehensive Standard of Financial Instruments.*

The International Accounting Standard Committee's (IASC) project manager for IAS 39, "Standard for Financial Instruments," stated, "current accounting practice for financial instruments varies widely around the world. The result is non-comparability and investor confusion."[241] This project took nine years and four public comment documents before the IASC published the standard, which is effective for annual financial statements covering periods beginning on or after January 1, 2001.[242]

IAS 39 is very similar to FAS 133. The only difference with IAS 39 is that it covers accounting for most financial instruments, which includes

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235 *See id.*

236 *See Tighter Disclosure Standards Eyed for Derivatives Deals, supra* note 229.

237 *See id.*

238 *See id.*

239 *See MOF to Set New Accounting System for Derivatives Deals, supra* note 232.

240 *See id.*

241 *See* International Accounting Standards Committee News, *IASC Publishes a Comprehensive Standard on Financial Instruments at* http://www.iasc.org.uk/news (visited Mar. 5, 1999). *See also* About International Accounting Standards Committee, *An Introduction to the IASC at* http://www.iasc.org.uk (visited Oct. 28, 1999). The IASC was formed in 1973. At present 143 accounting organizations in 104 countries are members. The IASC prepares International Accounting Standards (IAS) in accordance with due process. These standards provide recommendations to its member for accounting and disclosure issues.

242 *See* International Accounting Standards Committee News, *supra* note 241.

derivatives.[243] IAS 39 has the same accounting treatment and requirements for the cash flow, fair value, and net investment in a foreign entity (Foreign Currency hedge).[244] The standard requires all derivatives to be reported on the balance sheet.[245] For the three hedge categories, the ineffective hedge amount must be reported in income as are all gains and losses from all other derivative transactions.[246]

IAS 39 also has new disclosure requirements. The major disclosure requirements are as follows:

1. Methods and assumptions used in estimating fair values;
2. Whether purchases of financial assets are accounted for at trade or settlement date;
3. A description of the enterprise's financial risk management objectives and policies;
4. For each category of hedge a description of the hedge; which financial instruments are designated as hedging instruments; and the nature of the risk hedged;
5. Significant items of income and expense and gains and losses resulting from financial assets and financial liabilities; whether they are included in net profit or loss or as a separate component of equity and, if in equity, a reconciliation of movements in and out of equity;
6. Details of securitization and repurchase agreements;
7. Nature, effect, and reasons for reclassification of financial assets from amortized cost to fair value; and
8. Nature and amount of any impairment loss or reversal of an impairment loss.[247]

IAS 39 should provide its 103 country members with standards that will fill one of the largest voids in financial statements because financial instruments are often the most substantial part of many companies' assets and liabilities.[248]

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[243] *See id.* IAS 39 excludes originated loans and receivables held to maturity investments. The Board listed three reasons for not including these instruments at this time: 1) the extent of the change would be required among many jurisdictions; 2) in many industries portfolio linkages of these assets to liabilities which continue to be measured at the amortized original amount; and 3) there remains a question as to whether measuring assets held to maturity at fair market value is relevant.

[244] *See id.*

[245] *See id.*

[246] *See id.*

[247] *Id.*

[248] *See id.*

E. *Basel Committee's Recommendations for Improved Transparency and Consistency Regarding the Disclosure of Derivative Activities*

The Basel Committee and the International Organization of Securities Commissioners ("IOSCO") published a joint report, *Recommendations for Public Disclosure of Trading and Derivative Activities of Banks and Securities Firms*.[249] The recommendations may be useful to other financial and non-financial companies with significant trading and derivatives activities.[250] This information may also be helpful for other bodies responsible for setting disclosure standards and with the continuation of work in the development of improved and harmonized disclosure standards.[251]

The efficient function of the financial markets and strong market discipline is facilitated by improved transparency of institutions' financial condition, performance, business activities, risk profile, and risk management practices.[252] Supervisory efforts can be reinforced by transparency in promoting safety and soundness in individual institutions and financial systems as a whole. A key element of strong market discipline is the transparency of derivative activity.[253] For an accurate evaluation of an entity's financial condition and risk exposure, timely and reliable information is imperative.[254] Since institutions can quickly change their financial position and risk exposure, depending on the current economic environment, with the use of derivatives it is very important that the disclosures are timely and forward looking.[255] To maintain a stable financial system in a world of "rapid financial innovation and increasing complexity"

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[249] *See generally* Basel Comm. on Banking Supervision & IOSCO Technical Comm., *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms* (1999) *at* http://www.iosco.org/docs-public/1999-disclosure_trading_derivatives-document.04.html (visited Mar. 23, 2000). The Basel Committee on Banking Supervisors is a committee of banking supervisory authorities that was established by the central bank of Governors of the G-10 in 1975. The committee consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The International Organization of Securities Commissioners (IOSCO) is an international regulatory body dealing with securities issues. The technical committee of IOSCO is a committee of supervisory authorities for securities firms in major industrialized countries. It consists of senior representatives of securities regulators from Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, Ontario, Netherlands, Quebec, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

[250] *See id.* at 5.

[251] *See id.*

[252] *See id.* at 4.

[253] *See id.* at 8.

[254] *See id.* at 7.

[255] *See id.*

strong risk management policies and controls that are prudently supervised and publicly disclosed are required.[256] Public disclosures should be consistent with the measurement of risk and the risk management strategies used internally.[257] Risk management improvements will be disclosed over time.[258]

Financial disclosure information that is consistent will allow financial statement users to make comparisons across entities and countries.[259] Meaningful summaries including both qualitative and quantitative information should be provided.[260] The qualitative information should include information about the trading and non-trading derivative activity (non-traded is used to hedge and manage risk, traded is used for speculation).[261] Summaries should also provide a clear picture of the extent and nature of the derivative activities and show how this activity contributes to the entity's earnings.[262]

The qualitative information should explain how trading and derivative activities fit into the business objectives, strategies, risk-taking philosophy and "how these activities affect the overall risk exposure of the entity."[263] All on- and off-balance sheet components should be addressed[264] and methods used to determine the fair value of its traded and non-traded derivatives should be discussed.[265]

A description of the accounting policies and methods used to recognize income for derivative activities should be provided.[266] This will allow financial statement users to understand any important differences that exist in the accounting method used for the various types and activities of derivative instruments.[267] Accounting is not consistent across borders or institutions so this information will allow the financial statement users to analyze companies on a comparative basis.[268] Any significant changes in accounting policies should be discussed, in addition to plans to adopt new accounting rules in the future.[269] New accounting rules may have a substantial effect on the financial statements.[270]

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256 *See id.* at 8.
257 *See id.*
258 *See id.*
259 *See id.*
260 *See id.* at 14.
261 *See id.*
262 *See id.*
263 *Id.* at 15.
264 *See id.*
265 *See id.* at 20.
266 *See id.* at 19.
267 *See id.*
268 *See id.*
269 *See id.* at 20.
270 *See id.*

The quantitative disclosures should provide a summary with information about the make-up of the trading portfolio and the use of the non-traded derivatives.[271] The market activity information should include the risk categories (interest rate, exchange rate, precious metals, other commodities and equities), the broad derivative type categories (futures, forwards, swaps and options), and the repricing dates.[272]

The recommendations of the Basel Report are not to replace any regulation or standard required in a particular jurisdiction.[273] But for those companies in markets that do not have a strong regulatory system, following these disclosure recommendations would give investors the information needed to make an informed investment decision.[274]

V. DO THE NEW ACCOUNTING AND DISCLOSURE CHANGES PROVIDE FINANCIAL STATEMENT USERS WITH ADEQUATE INFORMATION ABOUT DERIVATIVES AND THEIR POTENTIAL RISK?

The United States, the United Kingdom and Japan, along with the IASC and the Basel Committee, have all made strides to provide more information to the users of financial statements so that the users may correctly assess the investment risk and make informed investment decisions. So far the United States has taken the most significant steps by providing both accounting and disclosure requirements. However, weaknesses still remain even after the changes in the U.S. requirements.

When the FASB undertook the derivative project, its main concern was to make derivatives visible to financial statement users by putting them on the balance sheet.[275] In addition, the FASB also wanted to ensure that the overall risk potential of a firm from its derivative use was accurately measured and reported.[276] FAS 133 now requires that derivatives be reported at market value on the balance sheet. Unfortunately, the potential risk will only be measured on a transaction by transaction basis.[277] This raises the issue of whether the user of the financial statements will be able to determine the overall risk position of an entity from the use of derivatives through the information provided following the new accounting and disclosure requirements.

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271 *See id.*

272 *See id.*

273 *See id.* at 5.

274 *See id.*

275 *See* Foster, *supra* note 8.

276 *See id.*

277 *See id.* at 781.

Under FAS 133, special accounting is allowed for hedges that are "highly effective."[278] This means that qualifying hedges are allowed to receive special accounting where only the ineffective portion of the hedge is reported in the income statement.[279] The ineffective portion is that part of the change in the value of the derivative that is not perfectly offset by the changes in the hedge's instrument.[280] Unfortunately, the FASB is vague about what "highly effective" means. There is some guidance in FAS 80, which states that if a hedge is 80% effective then it is considered highly effective.[281] However, FAS 80 is also unclear, in that it provides guidance for a highly effective correlation, not a hedge.[282]

FAS 133 also allows companies relief from having to constantly assess whether their derivatives are perfectly effective - where the change in the fair value of the hedge instrument exactly matches the change in the fair value of the derivative.[283] If a derivative meets certain criteria, FAS 133 allows what is called the short-cut method.[284] The short-cut method assumes these derivatives are highly effective with no ineffective portion to report in income.[285] Companies can assume that the changes in the fair value of the hedge item and the derivative exactly match.[286] Therefore, there is no reporting of the ineffective portion, and the financial statement user will only see how the change in the value of the hedged items is exactly offset by the change in the value of the derivative. As a result the true changes in value will be hidden.

The short-cut method is used for swaps and commodity forwards.[287] FAS 133 specifically acknowledged that the interest rate swap criteria results in credit spread changes being treated differently than swaps that meet the short-cut method criteria.[288] The short-cut method overlooks any ineffectiveness that could result in an interest rate swap due to changes in credit spreads; therefore, companies will strive to meet the "perfectly effective" short-cut criteria, and thereby avoid full disclosure.[289]

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278 *See* ERNST & YOUNG, *supra* note 35, at 10.

279 *See id.*

280 *See id.*

281 *See id.*

282 *See id.*

283 *See id.* at 12.

284 *See id.*

285 *See id.*

286 *See id.*

287 *See id.* at 17.

288 *See id.*

289 *Id.*

Under the new requirements, a hedge must be documented as such at inception.[290] The documentation must identify the relationship of the hedge and derivative, the specific derivative, the hedged item, the nature of the particular risk being hedged, and how the instrument's effectiveness will be measured.[291] This documentation is much more extensive than prior to FAS 133. Although an entity cannot wait to see how the hedge performs before the entity designates it as a certain type of hedge, there is still room for some discretion as to how the hedge will be designated to meet the entity's financial statement presentation objective.[292] This discretionary leeway afforded to the entity also explains how the same hedged item and derivative can be reported differently from firm to firm, which may result in confusing or even misleading financial statements when making a comparison between firms.

Although the "effectiveness assessment" discussed above is more flexible and may be easier to follow for the preparer of the financial statement, it also may allow for potential abuse and a disparity of accounting techniques.[293] A company may try to meet the short-cut criteria to avoid reporting any of the hedge's ineffectiveness in the income statement. As a result, financial statement users may not be able to determine if the risk management objectives for these derivatives are being met. In the future, if it is shown that an entity can get around the reporting of the ineffective portion of the hedge by qualifying for the short-cut method, the FASB may have to revisit this issue again and require a more specific effectiveness test.[294] Given this risk for manipulation, it may have been more prudent for the FASB to consider this now than to wait until another wave of large financial losses are reported.

Originally the FASB wanted the new requirements to show the entity's overall risk reduction resulting from derivative use.[295] However, FAS 133 only requires a company to show risk reduction on a transaction-by-transaction basis.[296] Because of this, it may be difficult for users of financial statements to determine the overall risk reduction or the potential risks from the derivative use as a whole. A single transaction may show that the risk is reduced for that one transaction, but when looking at all the derivative transactions, the entity's risk reduction may be minimal and this in turn may pose a greater risk potential to the financial condition of the entity.

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290 *See id.*

291 *See id.*

292 *See id.*

293 *See* Wilson, *supra* note 136.

294 *See id.*

295 *See* Foster, *supra* note 8.

296 *See id.*

Given the new FASB requirements, different accounting methods can be used for basically the same transaction.[297] For example, a company whose hedge strategy is to establish an asset-liability match can account for the same hedging instrument differently than if the company designated the instrument as a hedge for debt.[298] The new accounting requirements may provide more comfort to the financial statement user than before. However, it is likely that additional comfort and assurance may have been provided if all hedges were accounted for using the same criteria and that the short-cut method was not allowed at all.

FAS 133 requires certain disclosures in the annual reports.[299] These disclosures include the entity's objectives and strategies for holding or issuing derivatives, descriptions of the entity's risk management policy for each type of hedge, and the net gain or loss recognized in earnings for the reporting period.[300] Although the new disclosure requirements provide more information to the financial statement user regarding the use of derivatives, there are some apparent weaknesses.

Because the short-cut method allowed for certain derivatives and the fact that "highly effective" hedges do not have to report any of the ineffective portion of the hedge in income, the net gain or loss recognized in earnings does not include all of the gains or losses recognized. Where losses are realized but not reported, the financial statement user is misinformed regarding the earnings and financial performance of the company. In the aggregate, it may be possible for these unreported losses to become substantial.

The disclosures are not supported by the external auditors' attestation.[301] It is felt that by placing the responsibility on the board of directors, the board will seek assurances from independent auditors about the effectiveness of the controls that are in place to ensure that the risk management and derivative policies are followed.[302] The question then becomes, what happens if the board of directors does not seek these assurances? How will the investor know if the assurance has been sought, let alone met?

In comparison, the United Kingdom has taken a less active role regarding derivative accounting. At the present time, the United Kingdom has only made changes in the disclosure requirements. Accounting changes are expected sometime after the turn of the century. The ASB's FRS 13 requires

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297 *See* Wilson, *supra* note 136.

298 *See id.*

299 *See* ERNST & YOUNG, *supra* note 35, at 45.

300 *See id.*

301 *See* Craig, *supra* note 205, at 40.

302 *See id.*

a narrative and numerical disclosures, which appear to be more inclusive than those disclosures required by the United States.

In the narrative component, FRS 13 requires that information regarding the impact of the derivative instruments on the entity's risk profile be disclosed. It also impacts how the risks arising from the financial instruments might affect the performance and financial condition of the entity, and how these risks are being managed.[303] This information would allow the financial statement user to see the "big picture" of what the entity objectives are and if they were effective. The financial statement user would also know how the financial condition of the entity might be affected by derivative use. Therefore, a potential investor would be able to decide if the risk accepted by the firm is something he or she may want to take on when investing in the company.

The numerical disclosures are intended to show how the objectives and policies were implemented, and they focus on the interest rate risk, currency risk, liquidity risk, fair values, and hedging activities.[304] Both the numerical and narrative disclosures are required to be attested to by external auditors.[305] This should provide comfort to the investor that the risk management policies and objectives are implemented according to management's plan and that the financial condition of the company reflects the results of these objectives.

The Japanese changes in accounting and disclosure requirements should provide more accurate information to users of their financial statements. The accounting requirements have changed the method of measurement from cost-basis to market value for derivatives.[306] This will give the investor more accurate information regarding the gains or losses realized.

Previously, the Japanese disclosure requirements regarding derivatives were very limited and not subject to external auditors' examination.[307] With the new disclosure requirements, all types of derivatives will be noted and disclosed to the financial statement user.[308] The entity's total volume of derivative trading will be disclosed, which includes information about the contents of the trade, the trading policy, purpose, risk, and risk management of each derivative transaction.[309] The volume of each transaction must also be included along with the method used to calculate the market value.[310]

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303 *See* ASB Standards in Issue – FRS 13, *supra* note 225.

304 *See id.*

305 *See id.*

306 *See* Shimada, *supra* note 227, at 392.

307 *See id.*

308 *See id*

309 *See id.*

310 *See id.*

Market value calculations may be arbitrary, but by including how the market value is calculated the investor will be provided with the information to complete across company comparisons. Information regarding the overall risk reduction or the potential risk to the firm's financial condition from its derivative activity will be provided to the investor with communication of the total volume of the company's derivative trading. However, due to the fact that market value accounting is new in Japan, it may cause some problems for investors in the initial stages of its implementation. Investors will have to learn this new accounting method and understand how it impacts the financial reports as a whole.

VI. CONCLUSION

The three countries analyzed, the IASC, and the Basel Committee, have all made positive contributions regarding improved disclosure of derivative risk. However, given that the new disclosure and reporting requirements have yet to be fully implemented, it is not yet clear whether the world financial and business community will have enough consistent, accurate, and detailed information to properly assess the risk. Financial regulators throughout the world are hoping that the United States' new accounting policy and disclosure requirements can be used as a template for an international standard that is acceptable to the world's leading stock markets.[311]

Even if fully accepted as a world standard, the United States' approach to risk disclosure has a number of weaknesses. To further complicate matters, Y2K issues have delayed the implementation of the United States' disclosure requirements until June 14, 2001. Looking ahead, if there is no standard for derivative disclosure, we may find that as the world financial markets become more unified, the global inconsistency of the disclosure requirements will result in an even greater disparity between perceived and actual derivative risk.

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[311] *See* Jim Kelly, *Derivatives Standard May be Delayed,* FIN. TIMES (LONDON), May 14, 1999, at 8.