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October 2000

FASB Enacts Rule Requiring Fair Value of Derivatives and Hedging Instruments

In recent years, derivatives have been widely used to provide flexibility in financing and investing. The increased use of derivatives has led to a host of complications in accounting for these financial instruments and determining the parameters for hedging. The Financial Accounting Standards Board developed Statement 133, *Accounting for Derivative Instruments and Hedging Activities*, to establish accounting standards for newer types of transactions involving derivatives.

The Statement most likely applies to companies that do not believe they are investing in financial instruments and are not consciously hedging. Originally issued in June of 1999, adoption of SFAS 133 was postponed until this year to give companies time to address issues associated with implementation of the Statement. Calendar year companies will be required to comply with SFAS 133 starting January 1, 2001.

The FASB has detailed in the Statement that, "An entity must recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value." This requirement is a dramatic departure from the previous rules. Financial officers of large companies have begun to develop internal systems to identify their financial instruments. The next step is complying with the comprehensive accounting requirements. Finally, these instruments must be valued at fair value.

VALUATION PROCESS VARIES

While accounting firms have developed expertise to help their clients through the accounting process, the determination of fair value in accordance with SEC guidelines, cannot be performed by a client's accounting firm. The determination of fair value of certain derivatives and hedging instruments is straightforward; companies can undoubtedly determine these values themselves.

However, for many types of derivatives the valuation process is highly specialized. For example, if convertible debt is held as an investment, the owner must value the conversion feature separately from the debt portion. Two more examples of derivatives which illustrate the variety of transactions covered by SFAS 133 follow.

The first example is an interest rate swap, in which a company paying a loan at a fixed interest rate later enters into a "hedge" contract with another bank and agrees to pay the second bank a fixed interest rate while receiving a variable interest rate. The fair market value of the interest rate swap would need to be reported on the balance sheet.

(continued)

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Another example which falls under SFAS 133 is a contract for the purchase of a U.S. Treasury security that provides for settlement at a date which would be later than normal for such an investment. Financial officers will likely be surprised at the number of transactions affected by the new rules.

Most corporations are familiar with the valuation of stock options, which are required for footnote disclosure in annual reports. Valuation of many types of derivatives involves factors similar to those considered when valuing options, such as the time value of money, volatility, and the life of the contract.

NATURE OF DERIVATIVES IMPORTANT

On the other hand, valuation of swaptions, caps, collars and floors (a few of the multitude of derivatives) involves a comprehension of the underlying asset on which the derivative is based as well as the terms of the specific contract. You may recall that a couple of years ago several prominent companies were hit with large losses in their derivative portfolios because they did not fully understand the basis of the derivatives.

At the behest of the SEC, Statement 133 was put in place so that shareholders could understand the nature of these investments, and more importantly realize the impact of these investments on the balance sheet and income statement. The Statement requires determining the fair value of all derivatives and hedging instruments on a quarterly basis. Further, changes in value must be accounted for each quarter. This means that companies must first develop a methodology for identifying derivatives and hedging instruments, and then develop a process for valuing them quarterly (if not monthly for internal financial reporting).

Valuation Research is able, as an independent professional firm, to value all of a client's derivatives and hedging instruments on a supportable basis. Alternatively, we are prepared to help our clients develop an internal methodology. In this way they can comply with SFAS 133, with perhaps an annual review by Valuation Research for the issuance of their 10-K.

In the future, the SEC will be scrutinizing registrant filings to ensure compliance with SFAS 133. The SEC's two main concerns are proper accounting determination (e.g. whether an item is a true hedge or not) and accurate valuation, with the gains and losses reported accurately. For more information regarding this type of valuation, please contact your Valuation Research representative or Richard B. Nordberg at (414) 221-6220. **VR**

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