FASB's Folly: A Look at the Misguided New Rules on Derivatives Valuation and Disclosure

Michael S. Lesak
Comments

FASB’s Folly: A Look at the Misguided New Rules on Derivatives Valuation and Disclosure

I. INTRODUCTION

Last July, a little-known organization consisting of seven private citizens voted six to one to proceed with a set of rules that will substantially alter the reported earnings and equity of America’s largest corporations and financial institutions. Once these rules are in effect, they will carry the weight of federal law.

The organization, the Financial Accounting Standards Board (“FASB”), is a private-sector group of accounting professionals charged by the Securities and Exchange Commission (“SEC”) to promulgate the nation’s accounting standards. The new rules, as enumerated in the FASB’s recent Statement of Financial Accounting Standards (“SFAS”) draft, Accounting for Derivative Instruments and for Hedging Activities, will radically change the way U.S. corporations and banks account for their derivatives holdings.

The proposed standard represents a marked shift from traditional accounting to what is known as “fair value” accounting. In the past, corporations accounted for securities such as derivatives at historical cost, the price originally paid for the instrument. The new rules dictate that companies “mark-to-market” derivatives investments to show their current values. Additionally, the new standard requires

3. See infra notes 97-109 and accompanying text.
5. See infra Part III.A.
7. See infra notes 127-28 and accompanying text.
8. See infra note 162 and accompanying text (discussing marking-to-market).
that companies account for the market changes of derivatives as gains and losses, thus affecting earnings. In the past, derivatives had little impact on a corporation’s earnings. Furthermore, publicly-traded companies will need to disclose substantial qualitative data regarding their usage of derivatives for hedging purposes.

The FASB and its supporters laud the changes as imperative to ensure financial transparency and utility for investors. The rule’s critics, including the corporate sector, some members of Congress, and the Federal Reserve Board, charge that the new standard is counter-productive, misleading, and threatening to market stability.

This Comment first introduces the nature and various uses of derivative instruments, the basis for financial accounting standards, and the current accounting treatment of derivatives. This Comment then discusses the FASB’s draft statement on derivatives, the criticism it has received, and the alternative approach suggested by Federal Reserve Board Chairman Alan Greenspan. Next, this Comment criticizes the FASB’s proposal as contradictory to the precepts of Generally Accepted Accounting Principles (“GAAP”) and counter-productive to corporations’ efforts to responsibly manage financial and other risks. Finally, this Comment proposes a more modest standard that balances the goals of financial transparency and prudent risk management.

II. BACKGROUND

A. A Thumbnail Sketch of Derivative Products

“Derivative” is a general term that describes a growing array of financial products. A derivative is a financial instrument that derives
(hence the name) its value from an underlying asset, reference rate, or index. Typically, derivatives are contractual agreements between two parties that involve little or no initial exchange of assets. The contracts represent future obligations for cash or assets.

1. Purposes

One of two purposes typically drives the utilization of derivatives: speculation or risk management. Speculators trade derivatives, seeking opportunities to profit from fluctuations in an underlying asset's value, without actually having to purchase the asset. Although speculators are credited for providing market liquidity, regulatory practices often discourage the speculators’ activities. Additionally, speculators receive the blame for many of the market's derivatives-related losses.

Because of the substantial losses attributed to speculative derivatives trading, critics often overlook the second purpose served by...
derivatives: risk management applications. In truth, dealers and end-users recognize that the primary function of derivative instruments is to manage risks for corporations, banks, insurance companies, and pension funds. Today, seventy-five percent of corporations and virtually all financial institutions admit to using derivatives for risk management.

Over the past thirty years, changes in international finance, technology, and regulation created new risks for corporations and financial institutions. These new risks contributed to the growing popularity of derivatives as risk management devices. While risks are inherent to the business process, not all risks that companies face are operational in nature. End-users often utilize derivatives to hedge against risks that are ancillary to a firm’s ordinary course of business, such as changes in interest rates, currency exchange rates, as the demise of Barings Bank (following over $1 billion in Nikkei index futures contracts losses), the bankruptcy of Orange County, California (after losing several billion dollars on inverse floaters), and Proctor & Gamble’s financial woes (pursuant to $196 million in leveraged currency swaps losses). See id.

32. See REYNOLDS, supra note 22, at 15. For instance, only one-quarter to one-third of the participants in the futures market can be classified as “speculators.” See MILLER, supra note 29, at 82.

33. “Dealers,” such as brokers and investment banking firms, design and sell derivatives. See REYNOLDS, supra note 22, at 8.

34. An “end-user” is a party, such as a corporation or a financial institution, that makes use of derivatives products in order to limit risk exposure. See id. at 181.

35. See id. at 7.

36. See id. at 21. Corporate users most commonly utilize foreign currency and interest rate derivatives products. See id. at 59. The SEC estimates that the current market for all derivatives products is about $70 trillion. See Jill Dutt, Battle of the Bean Counters, INVESTMENT DEALERS’ DIG., Oct. 27, 1997, at 16, 17.

37. See generally Dutt, supra note 36, at 16 (mentioning phenomena affecting businesses and the financial markets). Some of the risks facing businesses today include currency and interest rate fluctuations, commodity and equity price shifts, and credit and liquidity risks. See REYNOLDS, supra note 22, at 23-24.

38. See MILLER, supra note 29, at 3-7. The transition from the Bretton-Woods system of fixed exchange rates to the market-based floating system is credited as one of the major factors contributing to the rise of derivatives usage. See id. at 4. The current managed float system subjects foreign exchange rates to increased volatility. See id. The new potential for wide fluctuations in exchange rates led corporations and financial institutions with international interests to seek out means by which to protect against sudden changes in foreign currency valuation. See id.


40. See id. at 34. “Hedging” generally refers to steps taken to limit or contain risk. See id. at 38. While derivatives can be used simultaneously for both speculative and risk management purposes, a “good hedge” is one where neither profit nor loss occurs. See id. Unanticipated gains or losses in a derivative used for hedging indicates a partial failure of the strategy to properly compliment the underlying risk. See id. at 37.
commodities prices, and equity market shifts.  

2. Exchange-Traded Derivatives Versus Over-the-Counter Traded Derivatives

Derivatives markets classify the instruments as either exchange-traded or privately traded over-the-counter ("OTC"). Many of a derivative's attributes depend upon the category to which it belongs. The markets standardize exchange-traded derivatives as to amount and duration. Purchasers place orders with brokers, while clearinghouses responsible for processing and matching trades guarantee the contracts. Due to the standardization and clearinghouse guarantees associated with exchange-traded derivatives, exchange traded derivatives are typically very liquid. Additionally, exchange-traded derivatives are regulated by the federal government.

OTC-traded derivatives are custom-made to the end-user's specifications and sold by dealers and investment banking firms. These instruments offer corporations more flexibility than their exchange-traded brethren, because they avoid standardization and are tailored to a corporation's needs. However, since OTC-traded instruments are private contracts, they are not guaranteed by a

Corporate treasurers recognize that unexpected profits on hedge strategies today will just as likely become unexpected losses sometime in the future. See Fred R. Bleakley, Treasurers of Many Multinational Firms Took Risks to Profit From Falling Dollar, WALL ST. J., Apr. 17, 1995, at A2.

41. See Using Derivatives, supra note 39, at 34.
42. See REYNOLDS, supra note 22, at 8.
44. See PETZEL, supra note 28, at 17-20. Because the clearinghouse guarantees each and every trade, corporations making use of exchange-traded derivatives must meet stringent credit requirements. See id. at 19-20.
46. See KOLB, supra note 23, at 15. Federal regulation is split between the Commodity Futures Trading Commission ("CFTC"), which oversees futures trading, and the SEC, which is responsible for options trading. See id.
47. See REYNOLDS, supra note 22, at 8.
48. See id. at 49. The limited delivery dates of standardized exchange-traded derivatives poses a frequent problem. See KOLB, supra note 23, at 15. Most exchange-based instruments expire just a few times a year, and are useful only for the short to intermediate range horizon. See id.
clearinghouse and thus, are susceptible to credit risk. Furthermore, in contrast to exchange-traded instruments, most OTC derivatives fall outside the scope of direct federal regulation.

3. Types of Derivatives

Two factors are inherent in every derivative. The first factor, the "underlying," is a variable. Underlyings include foreign exchange rates, interest rates, the price of a security or a commodity, or an index of one or any combination of the above. The second factor, the "notional," is a predetermined amount of currency or physical quantity of an asset. The product of the two factors determines the amount of cash or assets to be exchanged between contracting parties at maturity.

Two basic types of derivatives products exist: forward-based and options-based. While these two building blocks can be used to construct innumerable financial instruments, derivatives are typically classified as either forwards, swaps, futures or options.

a. Forward-based Instruments

Forward contracts are the simplest types of derivatives products. Forwards are agreements between two parties to buy and sell particular

---

49. See Bish, supra note 43, at 544. Unlike exchange-traded derivatives, OTC instruments tend to be substantially less liquid, creating difficulties for investors who wish to trade them prior to the delivery date. See Kolb, supra note 23, at 14-15.

50. See Kolb, supra note 23, at 15.

51. See Jenkins Testimony, supra note 24.

52. See id.

53. See id. An underlying is the asset that "underlies" the derivative. See Reynolds, supra note 22, at 191.

54. See Jenkins Testimony, supra note 24. Examples of notionals include an agreed upon amount of Japanese Yen, bushels of grain, or ounces of gold. See id.

55. See id. The product is equal to the underlying multiplied by the notional. See id.


57. See id. Combinations of the basic derivatives building blocks are known as synthetic instruments. See Kolb, supra note 23, at 155. Synthetic instruments are created to mimic the same value as the underlying asset that is being hedged. See id. Some of the more "exotic" synthetic instruments include digital swaps, dynamite warrants, exploding options, FX range floating rate notes, and kitchen sink bonds. See Joseph L. Motes III, Comment, A Primer on the Trade and Regulation of Derivatives Instruments, 49 SMU L. Rev. 579, 597-98 (1996).

58. See Motes, supra note 57, at 584; see also Reynolds, supra note 22, at 9-12. Swaps and futures are also referred to as forward-based. See id. at 9.

59. See Reynolds, supra note 22, at 9. Foreign currency exchange forwards, agricultural and physical commodities, and forward rate agreements ("FRA's") are common examples of forward contracts. See id. at 71.
assets at a predetermined price and date in the future. Typically, neither money nor assets change hands until the settlement date. Because forwards are customized as to their amount and term, they are classified as OTC derivatives. Due to the relatively expensive nature of forwards, large corporations and financial institutions are typically the only entities capable of utilizing them. Forward contracts can be particularly useful in reducing exchange rate risks inherent to international trade and investment.

Swaps, another type of forward-based OTC derivatives, are agreements between two parties to exchange sets of cash flows over a future period. The two most common types of swaps are interest rate swaps and foreign currency swaps. Swaps allow counter parties access to each others’ interest rates or currencies on terms more

60. See id. at 9.
62. Christian O. Nagler, Derivatives Disclosure Requirements: Here We Go Again, 6 CORNELL J.L. & PUB. POL’Y 441, 443-444 (1997); see also REYNOLDS, supra note 22, at 9.
63. See MAURICE D. LEVI, INTERNATIONAL FINANCE: THE MARKETS AND FINANCIAL MANAGEMENT OF MULTINATIONAL BUSINESS, 79-81 (3d ed. 1996). The customized nature of forwards contracts tends to result in larger transaction costs. See id.
64. See id. at 58. For example, suppose an American corporation contracts to purchase assets from a Japanese firm. Delivery will occur six months from the date of contract, at which time the contract price, payable in Japanese Yen, is due. The American corporation may purchase a foreign currency forward to hedge against anticipated appreciation of the Yen vis-à-vis the Dollar. Left unhedged, an upward shift in the exchange value of the Yen would expose the American corporation to increased costs, even though the price tag for the assets remained the same. However, should the Yen depreciate during the six-month period, the American corporation must still honor the forward contract, and thus, would have been better off not hedging. See id. at 84.

While useful hedging devices, forwards are one of the most rigid of all basic derivatives. See PETZEL, supra note 28, at 5-6. Once consummated, forward contracts cannot be modified without the consent of the counterparty, making for an inflexible method for hedging against unknown contingencies. See id.
65. See Motes, supra note 57, at 590.
66. See KOLB, supra note 23, at 8. Most swaps have two components: a spot transaction, followed by a forward transaction in the opposite direction. See LEVI, supra note 63, at 66.
67. See KOLB, supra note 23, at 123. Interest rate swaps are tied to the value of underlying debt instruments, and typically involve one party with a fixed-rate debt position and a counterparty with a floating-rate debt instrument. See id. By “swapping” positions, the floating rate party can obviate the risk of rising interest rates, while the fixed rate party simultaneously hedges against falling rates. See id. at 127.
68. See id. at 123. A mutual desire for funds denominated in a foreign currency typically precipitates a currency swap. See id. at 128-29. The arrangement consists of two parties trading currencies for a fixed period of time, during which they pay each other the net difference between the two currencies’ prevailing interest rates. See id.
favorable than those available to each party individually.\textsuperscript{69}

Futures contracts are also forward-based derivatives\textsuperscript{70} and are very similar to forwards in terms of construction and obligation.\textsuperscript{71} Futures contracts, like forwards, are agreements between two parties to buy and sell a particular asset at a predetermined price and date in the future.\textsuperscript{72} However, futures contracts, unlike forwards, are standardized, exchange-traded products.\textsuperscript{73} Futures are also cheaper and more widely accessible than forwards,\textsuperscript{74} mainly due to the fact that trading occurs on margin accounts, and contracts are marked-to-market and settled on a daily basis.\textsuperscript{75} Hence, the parties’ only up-front cost is the continued maintenance of their margin accounts.\textsuperscript{76}

b. Options-based Instruments

Options grant their owners the right, but not the obligation, to purchase or sell the underlying asset at a predetermined price during an agreed-upon period of time.\textsuperscript{77} This right is acquired in exchange for the payment of a premium.\textsuperscript{78} Fundamentally, there are two types of options: puts and calls.\textsuperscript{79} A “put” is the right to sell, whereas a “call”

\textsuperscript{69} See Reynolds, supra note 22, at 77-78.
\textsuperscript{70} See id. at 71.
\textsuperscript{71} See id. at 73.
\textsuperscript{72} See id.
\textsuperscript{73} See id.; see also Nagler, supra note 62, at 444.
\textsuperscript{74} See Reynolds, supra note 22, at 73. Since futures are exchange-traded, they are guaranteed by a clearinghouse. See Kolb, supra note 23, at 4. This reduction of credit risk permits more participants to enter the market. See Reynolds, supra note 22, at 73. Furthermore, futures contracts tend to be much smaller than forwards, thus increasing their availability to a larger number of businesses. See id.
\textsuperscript{75} See Reynolds, supra note 22, at 84. When trading in the futures markets, an investor does not pay for the full price of a contract up front. See Petzel, supra note 28, at 20-21. Rather, a small percentage, known as a margin, is required to protect the clearinghouse against one-day fluctuations in value. See id. At the end of each day, contracts are marked-to-market and margin accounts are adjusted accordingly. See id. Should losses lead an account to drop below a minimum “maintenance” level (usually 75\% of the original margin), the investor will receive a margin call, thus obliging him to bring the account back up to its original level. See id.
\textsuperscript{76} See Petzel, supra note 28, at 21.
\textsuperscript{77} See Reynolds, supra note 22, at 91. Options and futures are very similar, the primary difference being that options have an asymmetric risk profile. See Petzel, supra note 28, at 35. Losses are limited to the premium paid for the option, whereas the payoff profile is potentially infinite in nature. See id.
\textsuperscript{78} See Reynolds, supra note 22, at 91. A “premium” is the price an end-user pays in consideration for an option. See Petzel, supra note 28, at 38. Because there is no obligation to exercise an option that is less favorable than prevailing market prices, the premium represents the maximum potential loss that an end-user could experience. See id. at 35-36.
\textsuperscript{79} See James T. Colburn, Trading in Options on Futures 6 (1990).
Options can be a useful alternative to forwards and futures, since they allow an end-user to benefit from favorable movements in the underlying, while avoiding corresponding losses.

**B. Financial Accounting Standards and Regulation**

The framework for adopting financial accounting standards in the United States is markedly different from the rest of the world. While other nations codify accounting standards by legislative authority, the United States subscribes to standard-setting by the accounting profession itself. The independence of the American system gains respect for its flexibility, timeliness and responsiveness to business concerns, and is considered much more effective than a statutory approach.

The prevailing standards for financial accounting in the United States are collectively known as GAAP. Developing over time and gaining acceptance by the financial community at large, GAAP is a compilation of fundamental standards and guidelines that strive to provide relevant, reliable accounting information to users. This information is gathered into financial statements at regular and equal intervals in order to provide a timely and comparable picture of a firm's economic state. The benefits of the information should

---

80. See id. at 6-7.
81. See REYNOLDS, supra note 22, at 91. For example, an American corporation may purchase a call option on Japanese Yen in anticipation of the currency's appreciation relative to the Dollar. If in fact the Yen does increase in value, the corporation would exercise its option to buy the currency at the lower contract price. However, if the Yen depreciates contrary to the corporation's forecast, the contract will simply expire. Thus, the firm will be able to realize the more advantageous spot rate. The spot rate refers to the current market price for immediate delivery. See KOLB, supra note 23, at 3. Hence, for the cost of the call premium, the corporation has locked in a maximum cost for the transaction, while leaving itself an "escape hatch" with which it can exploit more favorable terms in the future. See supra notes 63-64 and accompanying text to compare this hedge scenario with a forward currency hedge scenario.
82. See Siegel, supra note 6, at 1841.
83. See id. at 1841-42.
84. See id. at 1845.
85. See id. at 1846.
87. See id.
89. See SKOUSEN ET AL., supra note 86, at 102-03. This is known as the "periodicity concept." See id.
always outweigh the costs of compiling the information.\textsuperscript{90} To promote accuracy and consistency, GAAP requires the recognition of expenses with their corresponding revenues; this is known as the "matching principle."\textsuperscript{91} Assets and liabilities are traditionally recognized at historical cost in order to ensure objective measurement.\textsuperscript{92}

The genesis of GAAP dates back to the early 1930s,\textsuperscript{93} following the passage of the Securities Act of 1933\textsuperscript{94} and the Securities Exchange Act of 1934.\textsuperscript{95} The Securities Acts created the SEC.\textsuperscript{96} Under the Securities Acts, the SEC may establish and enforce financial accounting standards for registrants.\textsuperscript{97} While the SEC has the administrative authority to enact financial accounting standards, since 1938, the agency deferred this task to the accounting profession.\textsuperscript{98}

Since 1938, independent, private-sector accounting bodies are primarily responsible for formulating financial accounting standards.\textsuperscript{99} In 1973, the SEC specifically recognized the FASB as the official source of GAAP.\textsuperscript{100} The FASB, comprised of a board of seven full-

\textsuperscript{90} See CHASTEEN ET AL., supra note 88, at 44-45. Generally, the costs associated with making accounting disclosures should not exceed the disclosures' corresponding benefits. See id.

\textsuperscript{91} See SKOUSEN ET AL., supra note 86, at 103-04. The matching principle provides for a rational allocation of expenses, and is used to recognize the cause and effect relationship between revenues earned and costs incurred. See CHASTEEN ET AL., supra note 88, at 59-60.

\textsuperscript{92} See SKOUSEN ET AL., supra note 86, at 11. Historical cost is defined as "the amounts originally paid for or received for goods and services in arm's-length transactions." See id.

\textsuperscript{93} See id. at 15.


\textsuperscript{97} See id. "Registrants" are corporations that, by virtue of certain size and ownership attributes, are obligated to comply with the SEC's reporting requirements. See id.

\textsuperscript{98} See id. at 19. The SEC opted to rely on the profession's existing financial accounting principles that were based on "substantial authoritative support." See id. (citing ACCOUNTING SERIES RELEASE No. 4 (Securities and Exchange Commission)).

\textsuperscript{99} See CHASTEEN ET AL., supra note 88, at 15. Promulgation typically occurs on an "as needed" basis and is usually precipitated by current conditions in the economic environment. See id. at 4-5.

Several professional accounting associations have participated in this promulgation. See MILLER & REDDING, supra note 96, at 19. For example, in 1938, the SEC recognized the Committee on Accounting Procedures—part of the American Institute of Certified Public Accountants ("AICPA")—as the primary source of GAAP. See id. at 19; see also SKOUSEN ET AL., supra note 86, at 15. From 1959 to 1973, the responsibility fell upon the Accounting Principles Board ("APB"). See id.

\textsuperscript{100} See MILLER & REDDING, supra note 96, at 20.
time members culled from the accounting profession,\textsuperscript{101} is responsible for adopting Statements of SFAS.\textsuperscript{102} A new standard is typically the product of a long process including internal study, exposure drafts, a period of public comment, revisions, and final adoption by the Board.\textsuperscript{103}

Although the SEC granted the FASB the authority to promulgate GAAP, the SEC still retains authority to enforce financial accounting standards,\textsuperscript{104} and to supersede the FASB with its own standards.\textsuperscript{105} The SEC also holds the power to reclaim complete control of accounting standards from the FASB.\textsuperscript{106} Furthermore, while Congress has no direct authority over the FASB, it retains oversight powers over the SEC.\textsuperscript{107}

The SEC rarely supersedes the FASB’s judgment on accounting standards.\textsuperscript{108} Since the SEC requires adherence to the standards set by the FASB, the independent body’s words carry the force of law.\textsuperscript{109} In addition, these standards apply not only to American SEC registrants, but also to foreign corporations wishing for their stock to be traded publicly in the United States.\textsuperscript{110}

\begin{itemize}
  \item \textsuperscript{101} See Siegel, supra note 6, at 1845-46. The current chairman of the FASB is Edward L. Jenkins, a former managing partner at Arthur Andersen, LLP. See Elizabeth MacDonald, Jenkins Takes FASB Helm with Focus on International Derivatives Issues, WALL ST. J., June 25, 1997, at B10. He assumed the position on July 1, 1997, and may serve a maximum of two five-year terms. See id.
  \item \textsuperscript{102} See Siegel, supra note 6, at 1846. There are currently 131 Statements of Financial Accounting Standards. See WILEY’S GAAP 1998: INTERACTION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Patrick E. Delaney et al. eds., 1998).
  \item \textsuperscript{103} See Siegel, supra note 6, at 1846.
  \item \textsuperscript{104} See MILLER & REDDING, supra note 96, at 20.
  \item \textsuperscript{105} See id. If, for example, the SEC were to take issue with a FASB standard—or lack thereof—the agency could establish its own rule, place a moratorium on the standard or practice in question, or explicitly overrule a FASB pronouncement. See CHASTEEN ET AL., supra note 88, at 15.
  \item \textsuperscript{106} See Robert Kuttner, How a Corporate Watchdog Nearly Lost Its Bite, BUS. WK., May 20, 1996, at 24.
  \item \textsuperscript{108} See MILLER & REDDING, supra note 96, at 20. But see CHASTEEN ET AL., supra note 88, at 15 (describing examples of SEC intervention into FASB accounting standards promulgation).
  \item \textsuperscript{109} See Jenkins Testimony, supra note 24; see also Dutt, supra note 36, at 19. (noting that FASB standards are the equivalent to SEC requirements in the context of public filings).
  \item \textsuperscript{110} See MacDonald, supra note 101, at B10.
\end{itemize}
Because of its quasi-legislative authority, the FASB’s actions are frequently the subject of intense scrutiny, criticism, and politicization. In recent years, a string of controversial proposals by the FASB instigated calls for an investigation into the continued efficacy of the independent standard-setting procedure. The corporate sector repeatedly rebukes the FASB for contributing to “standards overload”—that is, passing too many complex rules that require businesses to make costly, confusing and sometimes counter-productive alterations in their financial accounting. The latest proposal by the FASB to fundamentally alter the financial accounting standards for derivative products has spawned even more criticism, from a more diverse chorus of opponents, than any other proposal in recent history.

C. Current Financial Accounting Standards for Derivatives

At present, no single comprehensive accounting standard applies to derivative instruments. Instead, businesses rely in part on several SFAS from the FASB and numerous guidelines from the SEC. In areas where formal rules are absent, corporations develop their own best practices to address valuation and disclosure concerns.

The current promulgated rules depend on the type of instrument used and its purpose. The FASB’s SFAS No. 119 requires corporations to distinguish between derivatives held for trading versus non-trading purposes. Traded derivatives must appear on the

112. See generally id. at 108. Recent controversies involving the FASB’s GAAP promulgation include a 1982 disclosure standard for oil and gas companies, and an overhaul of financial accounting requirements for corporate stock compensation plans in 1993. See Chasteen et al., supra note 88, at 7, 15.
113. See Miller & Redding, supra note 96, at 139-143.
114. See generally infra Part III.B.
115. See Using Derivatives, supra note 39, at 38.
117. See Dutt, supra note 1, at H1. The SEC has adopted guidelines regulating how publicly-held corporations disclose derivatives on their financial statements. See id.
118. See id.
119. See Using Derivatives, supra note 39, at 38.
120. See id.
financial statements at their average fair values during the reporting period, while net gains or losses must be recognized as a component of net income at the end of each period. Meanwhile, corporations holding derivatives for purposes other than trading must provide information within the financial statements' footnotes on the objectives of the instrument and the recognition and measurement of the instrument. SFAS No. 119 encourages, but does not require, total disclosure of all qualitative factors relating to derivatives held for hedging purposes. However, SFAS No. 119 excludes coverage of most commodities forwards, swaps, futures, and options. Furthermore, the standard applies only to free-standing derivatives, and not to embedded derivatives.

Current practice dictates that corporations use historical cost accounting when recording assets and liabilities on balance sheets. Hence, the balance sheet carries derivatives with an identifiable historical cost. However, because most derivatives involve little or no initial exchanges of cash or assets, they have no discernible historical cost and rarely appear on a corporation's balance sheet. Instead, quarterly and annual financial statements incorporate several additional pages of explanatory footnotes. Pursuant to current FASB and SEC requirements, these footnotes detail the corporation's use of derivatives, their estimated fair market values, and potential risk exposures.

121. The FASB defines "fair value" as the dollar amount for which a derivative could be willingly exchanged in an arms-length transaction that is not a forced sale or liquidation. See Herz, supra note 116, at 362.
122. See id. at 420.
123. See Using Derivatives, supra note 39, at 38.
124. See id.
125. See Herz, supra note 116, at 421.
126. See id. A debt instrument that is issued by one company and convertible into the equity of another is an example of an embedded derivative. See Dutt, supra note 36, at 16, 17. Current accounting rules permit these products to be valued as single instruments and treated the same as a free-standing, or pure, derivative instruments, such as a foreign currency future, for accounting purposes. See id.
127. See supra note 92 and accompanying text (discussing historical cost).
128. See Dutt, supra note 1, at H1.
129. See Jenkins Testimony, supra note 24.
131. See id.
132. See Dutt, supra note 1, at H1.
133. See id. For an example of the current method of disclosing derivative products via financial statement footnotes, see Herz, supra note 116, at 428-430 (illustrating Exxon Corporation's use of derivatives disclosures in its 1994 annual reports).
Not only are derivatives largely absent from a corporation’s balance sheet, they are also generally absent from a corporation’s income statement. This absence is primarily due to a practice known as hedge accounting. Pursuant to the matching principle, hedge accounting recognizes gains or losses on a derivative in the same period it recognizes losses or gains on the hedged position. Hence, interim fluctuations on a derivative product currently have no impact on a corporation’s statement of earnings.

Critics of the current rules complain of inconsistency and lack of comprehensive guidance. They argue that the prevailing disclosure requirements allow corporations to bury their involvement, exposure, and losses in the derivatives market in financial statement footnotes. Critics allege that hedge accounting falls prey to manipulation, particularly by companies seeking to engage in speculative “imperfect hedges,” while accounting for the transaction as if it were strictly a risk management strategy. Additionally, critics claim that reliance on historical cost valuation paints a stale picture of a corporation’s true financial position, and keeps most derivatives off the balance sheet.

134. See Dutt, supra note 1, at H1.
135. See Herz, supra note 116, at 356.
136. See supra note 91 and accompanying text (discussing the matching principle).
137. See Herz, supra note 116, at 356.
138. See Dutt, supra note 1, at H1.
139. See Herz, supra note 116, at 425.
140. See id.
141. See id. Critics charge that current valuation and recognition standards permit corporations to manipulate cash flows through selective recognition of derivatives gains and losses, thereby creating artificially stable earnings that attract unwitting investors. See Roger Lowenstein, Corporate America Bullies FASB, Part II, WALL ST. J., Sept. 11, 1997, at Cl.
142. See Lowenstein, supra note 141, at Cl. Imperfect hedges occur when a derivatives strategy does not perfectly cancel out the underlying risk, thus setting the stage for potential gains or losses in excess of the underlying’s movement. See id. Critics suggest that imperfect hedges are used by corporate treasurers as speculative devices in an attempt to reap profits from what is publicly represented as merely a risk management tool. See id.
143. See Jenkins Testimony, supra note 24. Because asset prices may change over time, due to factors such as inflation or demand shifts, historical cost may become less relevant to investors and creditors. See CHASTEEN ET AL., supra note 88, at 56-57.
144. See supra notes 127-31 and accompanying text.
III. DISCUSSION

A. FASB's Draft Statement on Derivatives Accounting

Recognizing that derivatives accounting lacked any comprehensive standard, the FASB initiated a project to study current issues and ultimately develop consistent standards. While the FASB project is more than ten years in the making, the organization began receiving considerable pressure for results in 1994, when sudden interest rate spikes led to several large, highly-publicized, derivatives losses. These events brought derivatives to the attention of many who were previously unaware of the presence or the role of derivatives in corporate financial operations.

On August 29, 1997, in an effort to address the lack of standard reporting guidelines and the mounting criticism against the current system, the FASB issued its draft standard, entitled Accounting for Derivative Instruments and for Hedging Activities. The FASB released the draft for a forty-five day "exposure" period, encouraging interested parties to examine the proposal, and to make any objections during this designated comment period. The FASB is currently considering the significance of comments received. Most likely, the FASB will revise the draft and release a final version sometime in late March 1998. The rule is scheduled to become effective June 15, 1999.

145. See Dutt, supra note 36, at 16-17.
146. See id.
147. See id.; see also supra note 31 and accompanying text (regarding recent instances of derivatives-related losses).
148. See Dutt, supra note 36, at 17.
149. FIN. ACCOUNTING STANDARDS BD., supra note 4.
150. See Jenkins Testimony, supra note 24.
151. See id.
152. See Paul Beckett, FASB Postpones Expected Proposals on Derivatives, WALL ST. J., Dec. 18, 1997, at B11. The FASB postponed the approval date, which was originally scheduled for December 1997. See id. Despite substantial criticism of the draft proposal, the FASB has expressed its intent to implement the new standard without much alteration. See Elizabeth MacDonald & Stephen E. Frank, FASB Rejects Fed Chairman's Request to Soften Proposed Rule on Derivatives, WALL ST. J., Aug. 12, 1997, at A2.
153. See Beckett, supra note 152, at B11. The FASB originally planned to implement the new standard on December 15, 1998, but has since decided to delay implementation for six months to allow end-users more time to familiarize themselves with the draft. See id.
If the 130-page draft proposal becomes effective, it will supersede SFAS No. 119. Its primary impact relates to derivatives disclosure and valuation requirements for registrant corporations. The standard requires companies to disclose additional qualitative and quantitative information on their derivatives to investors. Disclosures must include the contract value of the instrument and its purported use or purpose. The draft requires that companies differentiate between the types of derivatives held and classify them as either hedging or speculative instruments. Companies must explain their hedging strategies, including the types of instruments used, the risks against which the company is hedging, and the anticipated exposures associated with the hedge.

The method of valuation will also change dramatically under the new proposal. All derivatives will appear on a company's financial statements. The instruments will be classified as assets and liabilities on the balance sheet and measured at fair value. Hence, at the end of each accounting period, a company must mark-to-market its derivatives holdings so as to reflect the instruments' current cash value. Like current practices, losses and gains for derivatives that qualify for hedge accounting will be matched with gains and losses in the hedged position. However, the new standard would more
rigorously classify imperfect hedges as speculative investments, while a company’s earnings will include gains or losses from these speculative investments. A new profit figure known as "comprehensive income" will include changes in the net worth of a company’s derivatives.

B. Reactions to FASB’s Draft Statement

The SEC praises the FASB draft proposal as an improved approach to providing investors with timely information on corporations’ derivatives positions and allowing investors to consider the potential impact of such holdings. The American Institute of Certified Public Accountants ("AICPA") also supports the new standard. However, because registrant companies and their auditors will have to make a substantial time and cost investment to abide by the new rules, the AICPA officially requested that the FASB delay the effective date of the rule to January 1, 2000.

Criticism for the FASB’s new derivatives proposal is much greater than simply the AICPA’s timing concerns. The banking industry, large corporations, the International Accounting Standards


164. See FIN. ACCOUNTING STANDARDS BD., supra note 4, at 11-12; see also supra note 142 and accompanying text (discussing the nature of imperfect hedges).

165. See Suzanne McGee & Elizabeth MacDonald, Pre-emptive Strike by Derivatives Players, WALL ST. J., Feb. 21, 1997, at C1. Unrelated gains and losses from derivatives will be reported in comprehensive income, allowing investors to discern whether a corporation has sold securities in order to smooth its profit picture. See Elizabeth MacDonald, FASB Rule Will Offer Walk on Wild Side, WALL ST. J., Sept. 30, 1997, at C1 [hereinafter Walk on Wild Side].

166. See Dutt, supra, note 1, at H1.

167. See Elizabeth MacDonald, CPA Group to Seek Delay of FASB Rule, WALL ST. J., Sept. 16, 1997, at A4. The AICPA is a professional association comprised of 331,000 CPAs. See id.

168. See id.

169. See id.


171. See Major Firms’ CEOs Urge FASB to Delay Rule on Derivatives, WALL ST. J.,
Committee ("IASC"), the Treasury Department, the Federal Reserve Board, and some members of Congress have attacked the FASB's proposal. Critics have not only requested postponement of the standard's effective date, but also they have held Congressional hearings and threatened blocking legislation.

Generally speaking, users of derivatives oppose increased regulations because they fear that such regulations will infringe on the utility of derivatives in hedging against risks. The primary criticism of the FASB proposal is that it will inject volatility into corporate...
Carrying derivatives on a company's financial statements could result in large variations in earnings, depending on the changes of the derivatives' market value. This variation in earnings would result from the proposal's requirement that instruments be marked-to-market and that the adjustments be treated as gains or losses prior to actual delivery or liquidation. While the derivatives are shown at market value, their corresponding assets or liabilities are recognized at historical cost until sale or liquidation. Hence, while the value of a company's derivatives holdings will change on each quarterly balance sheet, the value of corresponding assets and liabilities will remain constant, regardless of economic changes in market value.

Thus, a company may pursue a successful risk management strategy where positions are carefully hedged by derivatives, and, therefore, minimize potential losses and maximize shareholder value. However, investors will only see one-half of the equation that sometimes takes the form of a derivative seemingly realizing spectacular gains or losses. Hence, prudent risk management may appear more like speculation in the financial statements.

Opponents of the FASB draft standard argue that these results are likely to be confusing to investors and harmful to companies' stock prices. Opponents claim that the artificial volatility will

---

180. See MacDonald, supra note 174, at B2. But see Lowenstein, supra note 141, at C1 (arguing that the FASB proposal "doesn't create volatility; it only unmasks it").

181. See MacDonald, supra note 174, at B2. For example, Bank of America estimates that once the new rules are adopted, pursuant to its use of interest rate hedging, a one-half percentage point movement on a 10-year Treasury Note yield would result in a ten percent swing in its reported earnings. See McGee & MacDonald, supra note 165, at C1.

182. See Dutt, supra note 1, at H1.

183. See id.

184. See id.

185. See id.

186. See id. Fannie Mae Senior Vice-President and Controller Sampath Rajappa noted that had the FASB proposal been in force in 1995, the company would have reported shareholder's equity at more than $2.2 billion its actual value. See id. This misleading variation is due to the change in the market value of the firm's derivatives contracts, rather than actual movement in the value of the underlying assets or liabilities. See id.

187. See id.

188. See McGee & MacDonald, supra note 165, at C1.

189. Analysts estimate that the new rules will likely expose many of the 30 companies comprising the Dow Jones Industrial Average to distorting volatility. See Walk on Wild Side, supra note 165, at C1 (citing a study by investment banking firm Bear, Stearns & Co.).
undermine the stability of a company’s shareholder equity and disrupt what otherwise may be steady gains in earnings—two characteristics that make corporate shares attractive to investors.\textsuperscript{190}

Due to the potentially negative ramifications accompanying changes in derivatives accounting, critics argue that some companies may choose to forgo otherwise useful hedging policies to avoid disclosure requirements and potential shareholder backlash.\textsuperscript{191} A disincentive to hedge risks could have a substantial negative impact on the market.\textsuperscript{192} For instance, if banks chose to forgo derivatives to hedge interest rate and credit risks, they would likely be forced to discontinue mortgage borrowing rate lock-in options for consumers, and to levy prepayment penalties against borrowers seeking to refinance when interest rates fall.\textsuperscript{193}

Opponents also cite the fact that many derivatives, particularly the OTC variety, have no readily discernible market value.\textsuperscript{194} Because OTC derivatives are customized, they are rarely traded.\textsuperscript{195} Since there is no effective market by which to measure the value of thinly-traded instruments, critics fear that companies will estimate fair value prices on an ad hoc basis, contingent on subjective assumptions and projected market conditions.\textsuperscript{196} This practice might increase the risk of

\textsuperscript{190} See Dutt, supra note 36, at 16. The FASB’s critics argue that the new standard would prevent companies from rolling over short-term derivatives to cover long-term exposures. See McGee & MacDonald, supra note 165, at C1. These strategies are employed to stabilize corporate earnings from quarter to quarter. See id. The new rules will disallow these strategies, leading to increased volatility in earnings. See id. Additionally, marking derivatives to market will inject unrealized gains and losses into shareholders’ equity, thereby increasing its volatility. See Herz, supra note 116, at 426-27.

\textsuperscript{191} See Peter Coy, \textit{Hey, FASB, What’s the Rush?}, Bus. Wk., Sept. 29, 1997, at 54. But see Bish, supra note 43, at 561 (arguing that increased transparency will actually contribute to the development of the derivatives market).

\textsuperscript{192} See Beckett, supra note 152, at B11.

\textsuperscript{193} See MacDonald, supra note 170, at A6. These potential complications precipitated Sen. Lauch Faircloth’s legislation exempting banks from the FASB’s derivatives standard. See supra note 178 and accompanying text.

\textsuperscript{194} See Herz, supra note 116, at 362; see also McGee & MacDonald, supra note 165, at C1 (noting the absence of a standardized means to value some derivatives products).

\textsuperscript{195} See Herz, supra note 116, at 362. This is in contrast to exchange-traded derivatives instruments, which are standardized and, hence, highly liquid. See supra notes 44-46 and accompanying text.

inconsistent and erroneous reporting, as well as intentional manipulation.\textsuperscript{197}

Additionally, critics state that measurement in fair value terms is inappropriate for derivatives.\textsuperscript{198} Users of financial statements are typically concerned with the overall effectiveness of the hedging strategy, rather than a mark-to-market valuation that is accurate at one moment and outdated the next.\textsuperscript{199} Furthermore, even if fair market valuation was desirable, experts state that the necessary tools for derivatives valuation are currently unavailable.\textsuperscript{200}

In addition to concerns regarding valuation and recognition, some corporations believe that disclosure requirements may lead to involuntary divulging of financial strategies.\textsuperscript{201} Hershey Foods Corporation CEO Kenneth Wolfe stated that the new FASB accounting requirements would cause his company to disclose explicit details about its proprietary cocoa hedging strategies.\textsuperscript{202} Hershey uses futures contracts to hedge against the movement of cocoa commodity prices.\textsuperscript{203} According to the new FASB derivatives rules, Hershey would have to recognize gains and losses from futures contracts they possess, in observance of the fair value requirement.\textsuperscript{204} These disclosures would reveal Hershey's hedging strategies, purchase timing, and pricing weaknesses to interested parties.\textsuperscript{205} This information would be of particular value to Hershey's competitors.\textsuperscript{206}

\begin{itemize}
\item \textsuperscript{197} See id.
\item \textsuperscript{198} See id.
\item \textsuperscript{199} See id. Roberts suggests that the true measure of a derivative is found in the final results of a firm's hedging strategies. See id. If the net result of the cash flows from derivatives and hedged items balance out over the life of the hedging transaction, the risk management strategy may be considered successful. See id. Thus, evidence of the success or failure of a firm's hedging policies is more useful in judging a company's financial standing than are mere snapshots of a derivative's current market value. See id.
\item \textsuperscript{200} See Dutt, supra note 1, at H1. Experts estimate that it will take more than a decade before derivatives users can develop all of the tools necessary to calculate the market value of all derivatives instruments. See id.
\item \textsuperscript{201} See Kiss and Tell, INVESTMENT DEALERS' DIG., Oct. 27, 1997, at 19.
\item \textsuperscript{202} See Wolfe Testimony, supra note 2.
\item \textsuperscript{203} See id. For example, if cocoa prices increase in the spot market, Hershey must pay more to continue to produce chocolate at a given rate. See id. However, the corresponding increase in Hershey's cocoa futures holdings should turn a profit and thus offset its increased production costs. See id.
\item \textsuperscript{204} See id.
\item \textsuperscript{205} See id. By backing into the transactions disclosed in Hershey's financial statements, analysts could determine the timing and pricing of the chocolate manufacturer's futures transactions. See id.
\item \textsuperscript{206} See id. Hershey's two primary competitors are Mars, a privately-owned company, and Nestle, a Swiss-based corporation. See id. Due to ownership and geography, neither of these two companies are required to abide by FASB accounting
because it allows them to take advantage of the same risk management strategies that Hershey bore the cost of developing, ultimately using the techniques against Hershey. Additionally, cocoa futures speculators could use the disclosures to anticipate Hershey’s trades, thereby profiting at the chocolate manufacturer’s expense.

Although Hershey has been using cocoa futures contracts to hedge price risk since 1925, the company intends to search for other risk management techniques if the FASB standard comes into effect. Hershey CEO Wolfe notes that each of the alternatives presently under review are more costly or less effective than the current strategy.

Critics are concerned that the FASB standard will also lead to increased litigation. Opponents predict that by introducing into the marketplace complex information that serves to increase apparent volatility in earnings and equity, a corresponding increase in shareholder suits is likely to follow. Litigation is the probable result of requiring corporations to do what the FASB itself is unsure how to accomplish: accurate mark-to-market valuation of customized financial derivatives. Because measurement tools are not yet available for all

standards. See id.

Furthermore, competitors like Mars and Nestle could use the disclosures as a predictor for Hershey’s production costs over future months. See id. Once the competitors estimate Hershey’s costs, they could launch promotions and make use of pricing discounts at times that exploit Hershey’s weaknesses. See id. These measures could be used to siphon off market share from Hershey and gain a competitive advantage. See id.

By following Hershey’s disclosures, cocoa futures speculators would be able to predict, with relative accuracy, the chocolate company’s futures market transactions. See id. Once speculators familiarize themselves with Hershey’s buying patterns, there will be an incentive to enter the market in front of the chocolate company, purchase large positions, and sell them back to Hershey at a premium. See id. at 4. This type of front-loaded “coattails” trading is likely to cause price distortions within the commodities markets. See id.

Although Hershey’s current hedging strategies are seen as cost-effective and successful, the corporate management believes that the FASB’s new rules would put Hershey at too great a competitive disadvantage to continue with current practices. See id.

These additional costs will likely be passed on to the consumers.

See Bish, supra note 43, at 570. There are expectations that the disclosures, particularly those appearing in Management Discussion and Analysis sections of quarterly and annual reports, would lead to increased exposure to shareholder litigation. See id.

The AICPA’s request that the FASB postpone the new derivatives standard’s effective date is highly suggestive of the fact that the professional accounting community is ill-prepared to meet the challenges of fair valuation. See MacDonald, supra note 167, at A4.
financial instruments, current efforts are often imprecise. Once disclosed in financial statements, critics fear that these pricing imperfections may lead to an onslaught of shareholder derivative suits.

Finally, some critics voice concerns that the new FASB rules will further delay accounting standards harmonization internationally. Foreign corporations desiring to list their stock on an American exchange must currently meet FASB financial accounting standards. In order to encourage economic integration and increased U.S. market liquidity, the AICPA participates in IASC efforts to homogenize accounting standards worldwide. Because the IASC rejects the new FASB standard on derivatives accounting, critics of the standard believe that its adoption moves the United States one step further from achieving global accounting standards.

Chairman of the Federal Reserve Board ("Fed"), Alan Greenspan, although rarely an active participant in such matters as accounting standards, is also an opponent of the new FASB proposal. Greenspan criticizes the FASB draft as "piecemeal" because it only imposes fair value requirements on derivatives, rather than on all financial instruments. Like other opponents of the FASB

215. See Miller, supra note 29, at 73. Due to the highly complex nature of many derivatives products, valuation can fluctuate from one minute to the next. See id.; see also supra notes 198-200 and accompanying text (discussing subjectivity of fair value derivatives pricing).

216. See Miller, supra note 29, at 73.

217. See Greenspan Goes on the Attack, supra note 172, at 15.

218. See MacDonald, supra note 101, at B10. Many foreign companies have asked that they be permitted to list their stocks for trading on U.S. exchanges while continuing to adhere to their native accounting standards. See id. The New York Stock Exchange ("NYSE") also supports increased foreign listings. See id. Nonetheless, the FASB is adamant in its requirement that foreign firms adopt United States GAAP, for fear that foreign rules may be inadequate. See id.


220. See Greenspan Goes on the Attack, supra note 172, at 15. The IASC board members determined that the FASB proposal was too cumbersome and confusing. See IASC Decides Against U.S. GAAP, CFO ALERT, Nov. 10, 1997, at 1, available in 1997 WL 14272118. The international organization would prefer to see an eventual total shift toward fair value accounting, rather than implementing an incremental approach. See id. Ultimately, the IASC decided that the new FASB standard's complications outweighed its benefits. See id.


222. See MacDonald, supra note 174, at B2.

223. See Letter from Alan Greenspan, Chairman, Board of Governors of the Federal
standard, Greenspan is concerned about the effect the rules will have on earnings and shareholders' equity volatility, fearing that volatility may discourage risk management. Additionally, Greenspan argues that the valuation requirements will impose large costs on derivatives end-users. Finally, the Fed Chairman suggests, along with other critics, that the FASB's adoption of the new rules may impede efforts towards internationalization of accounting standards.

C. The Greenspan Alternative

Not only has Greenspan criticized the new FASB draft proposal, but he also has advanced an alternative approach. In his most recent correspondence with FASB Chairman Edward Jenkins, Greenspan asks that the FASB abandon the draft proposal and opt instead for a more flexible and moderate approach to derivatives accounting standards.

Reserve System, to Edmund L. Jenkins, Chairman, Financial Accounting Standards Board (July 31, 1997) (visited Nov. 15, 1997) <http://www.fasb.org> [hereinafter Greenspan Letter]. Greenspan's concerns reflect the fact that while derivatives will be adjusted to reflect prevailing market prices at the conclusion of each accounting period, the hedged assets and liabilities will remain at historical cost, thus creating a lopsided picture of a firm's financial position. See Dutt, supra note 1, at H1.

224. See Greenspan Letter, supra note 223, at 3. Greenspan believes the new rules would reduce the reliability of corporate financial statements and contribute to shareholder confusion. See id. Additionally, he expresses concern that the FASB standard may permit abuses arising from overstatements and understatements of asset and liability values. See id.; see also notes 190-92 and accompanying text.

225. See Greenspan Letter, supra note 223, at 3. Greenspan raises many of the same concerns as the other critics of the FASB proposal. See supra notes 179-224 and accompanying text (discussing the various problems with the FASB draft proposal, as alleged by its opponents).

226. See Greenspan Letter, supra note 223, at 2. In addition to the unwarranted increases in earnings and equity volatility, the systemic costs associated with the FASB standard may further discourage derivatives use among companies. See id. End-users will have to incur large costs developing new valuation tools. See Dutt, supra note 1, at H1.

227. See Greenspan Letter, supra note 223, at 2-3. Chairman Greenspan was one of the first to suggest that, contrary to prevailing wisdom, the FASB would encounter difficulties with convincing the IASC to adopt the new derivatives rules. Cf. Christopher Adams, Radical Accounting Standard Plan Wins Backing, FIN. TIMES (London), Sept. 9, 1997, at 4, available in LEXIS, Bankng Library, Fintme Library. However, the IASC ultimately rejected the proposed GAAP standard. See IASC Decides Against U.S. GAAP, supra note 220, at 1. Like Greenspan, the IASC criticizes the FASB draft as piecemeal. See id. The organization prefers an eventual across-the-board shift to fair value accounting. See id.

228. See MacDonald, supra note 174, at B2.

229. See Greenspan Goes on the Attack, supra note 172, at 15.
Essentially, Greenspan suggests that the FASB retain the historical cost treatment of derivatives on the primary financial statements while adopting supplementary statements that carry fair market valuations for both the derivatives instruments and the corresponding assets and financial products. He also recommends the continuation of simple hedge accounting for derivatives based on the best methods of current practice.

Chairman Greenspan asserts that this alternative approach would provide as much, if not more, transparency of financial standing to investors and creditors, as would the new FASB standard. However, it would do so without the added confusion of switching fundamental accounting methods. Thus, this method would be more useful to investors while simultaneously avoiding the creation of perverse disincentives to hedge risks. The Greenspan approach would also foster a “competition” between the primary and supplemental financial statements, allowing fair value accounting techniques to improve over time and to eventually win acceptance based on proven utility. Additionally, the opportunity would exist to, over time, develop more effective market valuation tools for illiquid derivatives.

Many of the FASB’s opponents welcome Chairman Greenspan’s alternative proposal. Nonetheless, the FASB is considered highly

230. See Greenspan Letter, supra note 223, at 3-4. This simplified approach would avoid potential mismatches between fair-valued derivatives and historical-valued hedged assets and liabilities. See id. at 4.

231. See id.

232. See id.

233. See id. By providing supplemental financial statements, the Greenspan approach would give investors an opportunity to view additional information about a firm’s financial activities while still having access to traditional statements to which users have become accustomed. See id.

234. See id.

235. See id. at 3-4. Hence, if financial statement users determine over time that fair value accounting is better suited for valuation and disclosure purposes, it will, by virtue of the markets, become the primary basis for accounting. See id. Greenspan analogizes this scenario to two mainframe computers, one old, the other new, running along side one another until the replacement is up to speed. See id. at 4.

236. See id. at 4. In the alternative, Chairman Greenspan suggests that the FASB at least initially limit the standard’s application to large corporations that are more active in the capital markets. See id. As larger entities with greater resources gain experience and innovate valuation techniques, the FASB standard could be shifted to smaller firms. See id. These firms would enjoy the benefits of the ensuing developments without having to bear the related costs. See id.

unlikely to significantly alter the terms of its derivatives standard.\textsuperscript{238}

IV. ANALYSIS

The FASB draft standard on derivatives accounting is at best, ahead of its time, and at worst, counter-productive. The fact that this arcane accounting issue has managed to draw so much fervor suggests that the FASB should not canonize the standard as GAAP.\textsuperscript{239} Simply put, fair value accounting for derivatives is not a \textit{generally accepted} accounting principle.\textsuperscript{240} Ideally, GAAP is a collection of accounting principles that have developed over time and enjoy widespread appeal within the financial community.\textsuperscript{241} In order to be effective, GAAP must be built on consensus among investors, creditors, practitioners, regulators, and reporting corporations.\textsuperscript{242} A failure to do so dilutes the authority of both the FASB and of GAAP.\textsuperscript{243} Clearly, there is no general acceptance of FASB's proposal.\textsuperscript{244}

A. The Proposal Fails to Provide a Full Picture of the Hedging Equation

The standard’s requirement that derivatives be marked-to-market and recognized in earnings is misguided for two reasons. First, this approach will allow investors to see only one half of the hedging


\textsuperscript{239} See \textit{Congress Isn't Done with Derivatives, Yet}, CFO ALERT, November 3, 1997, at 1, available in 1997 WL 14272085.

\textsuperscript{240} See id. Rep. Baker accuses the FASB of trying to "impose" a generally accepted accounting principle when there is no general acceptance that it is appropriate. See id.

\textsuperscript{241} See supra notes 86-103 and accompanying text (discussing GAAP).


\textsuperscript{243} See MILLER & REDDING, supra note 96, at 139-143.

\textsuperscript{244} See \textit{Fed Fight, supra} note 242, at 13; see also Part III-B. The FASB recently released a summary of the composition of the comment letters it received addressing the new derivatives standard. See Katherine M. Reynolds, \textit{FASB Rejects Requests for Changes to Rule}, THE BOND BUYER, Nov. 10, 1997, at 39. The letter noted that 40% of all respondents opposed the FASB proposal, and another 15% support it only with modifications. See id. Only 10% of the respondents supported the draft proposal in its current form. See id. This clear absence of agreement indicates serious problems with issuing the SFAS as a viable addition to GAAP. See id.
While derivatives are adjusted to fair value, the corresponding assets and financial instruments for which they are used to hedge will remain at historical cost. The ensuing volatility will be largely artificial, yet the corporations that undertake these otherwise sensible risk management strategies surely will be penalized by the raw numbers. While corporations using derivatives that qualify for hedge accounting can escape these inaccuracies, the strict qualifying criteria that the FASB intends to use means few in practice will. Rarely is a hedge "perfect," in that it completely obviates the underlying risk. This is particularly true for customized instruments.

The FASB's approach to derivatives accounting seems antithetical to GAAP's founding precepts of providing reliable and relevant information to users of financial statements. Accounting information that provides reliable insights regarding a company's cash flows is more valuable to investors and creditors than that which merely illustrates a business at liquidation value. Furthermore, should the rule cause some companies to avoid hedging opportunities for fear of investor backlash, the standard will be squarely in

245. See supra notes 185-190 and accompanying text (illustrating potential confusion arising from using inconsistent valuation methods for derivatives and hedged assets and liabilities).
246. See text accompanying notes 182-84.
247. See Fed Fight, supra note 242, at 13; see also Dutt, supra note 36, at 16. (discussing how artificial volatility will upset the stability of shareholder equity and distort what may in reality be steady gains in earnings-two characteristics that make corporate shares attractive to investors).
248. See Lowenstein, supra note 141, at C1; see also FIN. ACCOUNTING STANDARDS Bd., supra note 4, at 12-13 (listing the criteria for determining whether a derivative qualifies for hedge accounting treatment); see also supra notes 135-38 and accompanying text (discussing hedge accounting).
250. See id. One strategy used to construct customized instruments is "cross hedging." Cross hedging typically results in imperfect hedges. See id. at 85. A cross hedge involves using a futures contract based on one asset to reduce the risk associated with another asset that "differs materially in location, type, grade, or maturity date." Id. at 86. Cross hedging is used where there is no direct method of risk management available. See id. at 85. While these instruments can be used to reduce a percentage of associated risk, they are rarely perfect. See id. at 85-86. Nonetheless, cross hedging makes up an important part of corporate risk management, particularly in terms of foreign currency transactions. See id. at 85.
251. See supra notes 86-92 and accompanying text.
252. See Lowenstein, supra note 141, at C1; see also supra notes 201-08 (discussing corporate management's impressions regarding the proper evaluation of derivatives strategies).
contravention to GAAP's pervasive contention that the benefits of financial accounting standards outweigh the related costs. 253

B. The Proposal Poses Compliance Difficulties

The second problem with the mark-to-market requirement is the compliance difficulties it imposes on SEC registrant corporations and on accounting and auditing firms. The tools for calculating fair value are not yet up to the task of providing accurate estimations. 254 Thus, in order to comply with the FASB standard, corporations will need to invest substantial time and resources to developing new valuation tools. 255 These systemic demands will come at a time when corporations are grappling with the emergence of the European Monetary Union ("EMU") 256 and the "Year 2000" computing crisis. 257

253. See supra note 90 and accompanying text. Some proponents of the standard question whether or not it will actually discourage corporate hedging practices. See Coy, supra note 191, at 54. Recently, however, a $700 million debt offering by Western Resources Inc. was scrapped for fear of the effects that the new FASB standard would have on accounting for embedded derivatives. See Dutt, supra note 36, at 16.

254. See supra notes 194-200 and accompanying text (discussing the lack of valuation methods for OTC derivatives).

255. See Dutt, supra note 1, at H1.

256. See Dutt, supra note 36, at 16. EMU is a product of the 1992 Maastricht Treaty. See Lionel Barber, Setting the Stage for the Single Currency, EUROPE, Sept., 1997, at ESR3. The plan calls for the replacement of qualifying European Union ("EU") members' currencies with a single European currency and the establishment of an independent European central bank to direct monetary policy for EMU participants. See id. at ESR4-5. The first phase of EMU will take place in Spring 1998, when the EU will determine which of its fifteen member states qualify for inclusions in EMU. See id. at ESR4. Qualification is based on member states meeting certain budgetary and inflation-based criteria. See Towards EMU: Kicking and Screaming into 1999, THE ECONOMIST, June 7th-13th, 1997, at 19, 20. January 1, 1999 will mark the second phase of single currency integration, when exchange rates will be irrevocably locked between participants. See Barber, supra, at ESR5. Phase three will commence on January 1, 2002, at which time Euro-currency will begin circulating. See id. American companies trading with and operating in Europe, as well as those that hold European-denominated financial products, will all be affected by the shift to a single currency. See Robert J. Guttman, An Interview with Yves-Thibault de Silguy, EUROPE, Sept. 1997, at ESR9, ESR10. Business with European ties will need to make substantial investments to upgrade their accounting, finance, and information technology systems in preparation for EMU. See Larry Summers, American Eyes on EMU, FIN. TIMES (London), Oct. 22, 1997, at 20, available in LEXIS, Banking Library, Fintme File.

257. See Dutt, supra note 36, at 16. The Year 2000 problem is due to a date flaw found in many mainframe, mid-size, and personal computers. See Stanley Zarowin, The Millennium Muddle, J. ACCT., Dec., 1997, at 33, 33. Since many older computer systems were designed to recognize the passage of years with two digits (e.g., "98" for 1998), the turn of the century will cause many systems to default to erroneous dates, such as 1900. See id. at 35. This seemingly innocuous error will affect banks, insurance carriers, corporations, securities firms, and auditors. See Lynn J. McKell & Marshall Romney, Risks and Liabilities: How CPAs Can Protect Themselves, J. OF ACCT., Dec.
In the meantime, corporations likely will encounter shareholder litigation caused by inevitable errors in valuation, while investors and creditors will be forced to rely upon unverifiable numbers derived from subjective and inconsistent methods.

Additionally, the difficulties the new FASB standard may present to international accounting standards harmonization should not be discounted. Numerous foreign corporations, which represent new opportunities for American investors, await the opportunity to list their stocks on the U.S. exchanges. These corporations offer greater liquidity to the market and encourage economic integration. The further the FASB moves away from the IASC, the longer it will take to reap these benefits.

V. PROPOSAL

While the FASB's interest in increasing financial statement transparency is admirable, the Board has an obligation to work with the corporate sector to achieve successful results. New requirements should not require disclosure simply for disclosure's sake. Financial accounting standards for derivatives should clarify, rather than confuse, the role of these financial instruments within corporate portfolios. For these reasons, a more incremental approach, such as the one suggested by Chairman Greenspan, emerges as the better option.

Because fair value accounting for derivatives has yet to earn the status of a generally accepted accounting principle, the FASB

1997, at 43, 44. An avalanche of litigation is expected to follow in the wake of misstatements in financial statements and muddled customer accounts. See id. at 43-44. Last minute efforts to correct the Year 2000 problem are likely to cost businesses an estimated $200 to $600 billion. See Zarowin, supra, at 34.

258. See supra notes 212-216 and accompanying text (discussing the likelihood of increased shareholder suits pursuant to inevitable errors and miscalculations of derivatives valuation).

259. See supra notes 194-197 and accompanying text for discussion on the subjective factors on which companies will inevitably base their value estimates.

260. See MacDonald, supra note 101, at B10.


262. See Greenspan Goes on the Attack, supra note 172, at 15.

263. See Congress Isn't Done with Derivatives, Yet, supra note 239, at 1.

264. See McGee & MacDonald, supra note 165, at C16.

265. See supra notes 245-50 and accompanying text (explaining how the new FASB reporting standards will confuse investors).

266. See Part III.C (discussing Chairman Greenspan's alternative proposal).

267. See supra notes 239-44 for a discussion on the failure of the FASB's new rule to gain the consensus support necessary for inclusion into GAAP.
should postpone the new standard’s implementation and extend the official comment period. Given that GAAP is, ideally, a cooperative effort aimed at adopting the best accounting practices in order to provide a universal means for reporting businesses’ financial attributes, the FASB ought not ignore the concerns expressed by the corporate sector. The FASB only drafts accounting rules; SEC registrants must determine viable and cost-effective strategies to implement them. Hence, the corporate sector has much to contribute in terms of designing workable accounting standards that balance usefulness and transparency with compliance costs.

For the time being, the FASB ought to maintain historical cost accounting as the primary method in financial statements since it has long been the accepted method for asset and liability valuation. While not without its flaws, historical cost valuation provides a constant and objective standard for assets and liabilities on the balance sheet. In addition, since fair value accounting is a relatively new concept that has yet to gain wide acceptance among generators and users of financial statements, the tools required to adequately calculate the market value for all existing financial instruments are not yet available.

Therefore, the FASB ought to implement a system where supplemental statements using fair value accompany the traditional financial statements. This method would expose investors to more information than is currently available while providing investors

268. See Review and Outlook: Dangerous Derivatives?, WALL ST. J., March 14, 1997, at A16 [hereinafter Dangerous Derivatives]. While the FASB has been adamant with its plan to implement the derivatives proposal on schedule, the comment period has led to changes in the draft. See Steven Goldstein, FASB Compromises on Proposals; Lawmakers Back Away, DERIVATIVES WK., July 28, 1997, at 1, available in LEXIS, Banking Library, Allnews File; see also MacDonald, supra note 173, at B8.

269. See supra notes 86-92 and accompanying text.

270. See Part III.B. (illustrating the concerns on the derivatives proposal raised by corporations).

271. See Dangerous Derivatives, supra note 268, at A16.

272. See Skousen et al., supra note 86, at 11-12.

273. See Chasteen et al., supra note 88, at 63-64. Since historical cost is determined by the fair market value of an item at the time of the transaction, it may not necessarily represent the current value of the item. See id. at 64. Factors such as inflation and appreciation are not taken into account. See id. at 63. Nevertheless, historical costs are “real” costs, representing actual transactions. See id.

274. See Siegel, supra note 6, at 1847-49.

275. See supra note 200 and accompanying text (noting that it will take more than a decade before all of the tools necessary to calculate the fair value of derivatives instruments will be available).

276. See supra notes 228-36 and accompanying text (discussing Chairman
with a choice: they may continue to rely on the traditional materials, shift to the fair value statements, or opt to consider the statements in their entirety.277 Hence, investors would be provided with more options, rather than having a new, unfamiliar and untested standard thrust upon them. This method would essentially leave the matter up to the preferences of the marketplace.278

If the FASB does persuade the market to accept fair value accounting as the primary standard, it ought to delay the shift until valuation methods catch up to the task. Since the systemic changes required for implementation of the new standard are significant, cost-benefit analysis is essential.279 Because businesses already face substantial costs due to the impending integration of the EMU and the "Year 2000" computer crisis,280 it would be imprudent to increase systems demands on firms prior to the passage of both of these events.

Ultimately, the FASB should strive to stay within its original charter as an independent body promulgating GAAP with the aid of the parties that generate and utilize the financial statements.281 Regulation of accounting standards in the United States differs from that of the rest of the world because it relies on the input and expertise of a myriad of knowledgeable parties.282 The American system provides a more flexible, timely, and responsive approach to business concerns than a legislative approach would provide.283 By imposing the new derivatives standard on SEC registrants, the FASB runs the risk of losing the benefits of this system. Any inducement to follow accounting principles that are not generally accepted deprives GAAP of its responsiveness and authority.284

Furthermore, the FASB might incite Congress enough for it to step in and legislate accounting standards.285 While corporations are quick

Greenspan's proposal).  
277. See supra note 233 and accompanying text.  
278. See Greenspan Letter, supra note 223, at 3-4.  
279. See id. at 2. The fact that the AICPA has requested that the FASB delay implementing the proposed derivatives standard is further evidence that the accounting profession is unsure as to how to meet the challenges associated with the new rule. See MacDonald, supra note 167, at A4.  
280. See supra notes 256-57 and accompanying text (discussing the nature of the two events and the scope of their expected economic impact).  
281. See supra notes 86-103 and accompanying text (regarding the historical origins of GAAP).  
282. See Siegel, supra note 6, at 1846.  
283. See id.  
284. See supra note 242-43 and accompanying text.  
285. See supra notes 177-178 (discussing the Congressional hearings and proposed legislation in response to the new derivatives standard).
to complain about the bureaucratic bungling of the FASB, a more efficient approach is unlikely to be achieved via direct intervention by the federal government.

VI. CONCLUSION

The FASB's derivatives proposal contradicts the primary goals of GAAP and is counter-productive to the corporate sector's efforts to responsibly manage financial risks. Rather than providing enhanced methods for investors and creditors to assess SEC registrant companies, the new accounting standard imposes radical changes that are, at best, ahead of their time. These new rules are a piecemeal approach to fair value accounting, an approach that those in the accounting profession are not prepared to implement.

The standard is certain to inject unwarranted volatility into companies' reported earnings and equity. These fluctuations will be confusing to shareholders and detrimental to the value of their investments. The rule will create a perverse incentive for some corporations to forgo otherwise sound risk management strategies, thus trading artificial volatility for increased risk exposure. Other businesses will seek to develop new derivatives products whose express purpose will be to avoid compliance with the FASB standard. In either case, the result will be added costs for companies, investors, and consumers alike.

Although this is not the first time the FASB has encountered opposition to its standards, rarely has the opposition been as visceral as that expressed in reaction to the draft proposal on derivatives. In moving forward, the FASB runs the risk of alienating itself from its corporate sector patrons, while providing an all-too-tempting opportunity for Congress to enter the fray and take control of America's independent financial accounting regulation.

MICHAEL S. LESAK

286. See generally Zweig & Foust, supra note 111, at 108-10 (illustrating some recent examples where the corporate sector has questioned the FASB's efficacy as a promulgator of financial accounting standards); see also Miller & Redding, supra note 96, at 139-143.