Complex derivatives come under greater scrutiny

By Charles Davidson
CONTRIBUTING WRITER

Even as the economy and stock markets have taken a beating the past three years, one class of investments — derivatives — has grown more and more popular. And the body that sets accounting rules in the United States is refining its guidelines in an effort to give investors a clearer picture of the true value of the derivatives on companies’ books.

Derivatives are essentially contracts, such as futures, options and mortgage-backed securities, whose value is linked to the value of an underlying investment. For example, the changing value of a crude oil futures contract depends on the movement of oil prices.

These instruments are dizzyingly complex and used by a handful of very large companies and banks to hedge against risks.

Although the circle that trades in derivatives is small, the total value of derivatives continues to climb. At the end of 2002, the value of the underlying investments of outstanding OTC contracts stood at $141.7 trillion, an 11 percent increase from the end of June 2002, according to the Bank for International Settlements (BIS). BIS serves as a bank for central banks, and aims to promote monetary and financial stability.

Derivatives have their critics, including super-investor Warren Buffett, who called them potentially lethal “financial weapons of mass destruction” in his annual letter to shareholders in March. Indeed, the effort to better account for derivatives is part of the broader debates that continue to swirl about accounting standards amid numerous corporate accounting scandals.

As the use of derivatives spread throughout the 1990s, so too did concern that the futures contracts were essentially not recorded on company books in current accounting; they would show up only after they were settled in the future, said Bryan Ives, leader of the capital markets group in the Charlotte, N.C., office of Alston & Bird LLP.

Ives said those concerns led the Financial Accounting Standards Board to issue new rules regarding how companies must account for derivatives. The rules came along in fits and starts, with temporary provisions issued until 2000. At that point, a new rule, FAS 133, took effect. It was amended in April.
FAS 133 and the recent amendment, FAS 149, are, Ives said, “exceedingly complex financial accounting standards. It is probably the poster child of complex rules-based accounting in the United States,” he said.

The aim of the amendment is, basically, to clarify the definition of a derivative for accounting purposes. In addition, it clarifies when a derivative contains a financing component that warrants special reporting in a company’s statement of cash flows.

These rules will affect a small handful of large public companies, many of them banks that securitize credit-card loans and other credits, experts said.

The new rules have made derivatives slightly less attractive to banks, said Joe Brannen, head of the Georgia Bankers Association. But they have not become so unwieldy that banks are turning away from them, he said.

“It’s an esoteric, complicated thing that most of our banks don’t even do,” Brannen said.

FASB Amendment 149 points up a deeper question about the nature of the rules designed to govern accounting in the United States, Ives said. That question boils down to whether the “rules-based” accounting approach used, as opposed to the “principles-based” standards used in most other industrialized nations, produces the most accurate picture of a company’s financial condition.

In the post-Enron days, some of the new standards are making the accounting rules still more rules-based, meaning, Ives said, that there’s less and less left to the judgment of accountants and other professionals. That might sound good in theory, but it’s questionable whether it ultimately leads to truer numbers.

“If I want truly representative statements, there’s simply not going to be a set of one-size-fits-all rules,” Ives said. “That’s what our accounting system has devolved into, an effort to write one-size-fits-all rules, which necessarily means the rules exponentially multiply. And that’s what we see with FAS 149.”

Some experts point out that the biggest underlying flaw in company accounting is that most numbers are not concrete facts but estimates.

Baruch Lev, a professor of accounting and finance at New York University’s Stern School of Business, told The Economist magazine that no amount of new accounting rules and auditing will change the reality that estimates are fragile and easy to manipulate.

“Our accounting system has devolved into an effort to write one-size-fits-all rules, which necessarily means the rules exponentially multiply.”

Bryan Ives
Aiston & Bird LLP