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by
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[Introductory notes: Robert H. Herz, CPA, FCA, is a partner with Coopers & Lybrand in New York City and is the firm's associate national director of Accounting and SEC Services. He has served as the audit partner for a number of his firm's major clients in the financial services industry, including several derivatives products dealers. He also heads Coopers & Lybrand's Financial Transactions Advisory Group, which advises investment bankers and corporate clients on the accounting and tax aspects of financial instruments, mergers and acquisitions, project financing, and hedging transactions. He is a member of his firm's Investment Committee, the Financial Accounting Standards Board's Financial Instruments Task Force, the AICPA SEC Regulations Committee, and the New York Stock Exchange's International Capital Markets Committee.

Mr. Herz has authored numerous publications, including the firm's monographs, *Foreign Currency Translation -- An Implementation Guide, and Coopers & Lybrand's Guide to Financial Instruments*, as well as other publications and articles on derivatives and various financial instruments. He is a U.S. CPA and an English Chartered Accountant.]

Derivatives! Hardly a day goes by without some major story appearing in the business press on this subject. To the press, the word has become virtually synonymous with bad investments and unexpected losses. To the average person on Main Street, the word either means Spanish for "evil" or the latest snake oil out of Wall Street. To Congress and regulators, it represents a major financial area that has somehow escaped direct regulation and that potentially threatens the demise of the western world as we know it. To the investment bankers and swap dealers, it represents a high-profit area, both in terms of proprietary trading revenues and in terms of sales of products to customers. To institutional investors, such as mutual funds, pension plans, college endowments, and state and local governmental authorities, it provides an intriguing yet potentially dangerous opportunity to enhance portfolio returns. To treasurers and corporate risk managers, derivatives provide a means to better manage a company's natural exposures to interest rate, commodity, and foreign exchange risks. To the SEC and the FASB, derivatives pose challenges both in terms of financial statement disclosures and on how companies should account for hedging and risk management activities. To boards of directors and external auditors, it represents an area of growing concern and potential liability. To the academic community, it represents -- well, we'll talk about that later.

So it is that there are a variety of competing objectives and concerns over derivatives at various levels. I call these the "derivatives wars." It is not just one war but various skirmishes and battles between opposing forces across a number of battle fronts, each seeking to do the "right thing."

My objective tonight is to provide you with some personal observations and views on the subject -- if you will, a battlefield report -- based on my own involvement and experiences in this area over the years. To put this in its proper context, let me give you an overview of my areas of involvement.

As associate national director of Accounting and SEC at Coopers & Lybrand, L.L.R, I am regularly involved in difficult accounting and disclosure issues that arise from our practice relating to derivatives and other financial instruments. My experience over the past few years has been that often the accounting and disclosures issues are merely the tip of the iceberg, with basic economic, financial, control, and behavioral aspects lying beneath the surface.

As a member of the FASB's Financial Instruments Task Force and hedging working group, I have also been involved in the accounting rule-setting in this area. Of course, I have witnessed firsthand the often painfully slow progress in dealing with what is a difficult and complex challenge to the accounting model.

Until recently, I headed a group within our firm that deals with the product developers on Wall Street, advising them on the accounting and tax structuring of new derivatives and financing techniques. After twelve years of involvement in that activity, I think I have gained a pretty good understanding of the motivation and psyche of these highly creative and very well-paid individuals.

I also count among my own audit clients several investment bankers and swap dealers. As you can imagine, the audits of these active traders of derivatives pose another set of challenges.

In the past year, I have also been involved in several control reviews of end users of derivatives at the behest of senior management and/or board of directors. While I am happy to report that in some of these cases the review was initiated by the company on a proactive basis and as a preventive measure, I have also been on the scene after the fact of several "derivatives disasters," diagnosing the sick, bayonetting the mortally wounded, and helping to heal the survivors.

Finally, I have over the years been and continue to be involved in my firm's internal policies and training efforts related to financial instruments in general and derivatives in particular.

I therefore liken my role to that of a platoon sergeant; that is, leading the troops in the audit and accounting battles, reporting up the line to the captains and colonels of senior management and boards of directors and audit committees, and every so often being given the opportunity to share my observations with the generals, such as regulators and rule-setters like the SEC and the FASB.

I am going to cover a lot of ground tonight and will provide you with my observations from the trenches on issues relating to regulation, involvement of boards of directors and senior management, internal controls, disclosure, accounting, and auditing of derivatives. I would also like to briefly pass on my views on how you, the academic community, should be involved in this area.

Please understand that I am more qualified to talk on certain of these matters, such as accounting and disclosure, than I am on others, such as regulation. That notwithstanding, I have never been accused of being bashful and will offer my views on all these topics. I hope you understand, however, that everything I say tonight are my own personal views and not necessarily the views of Coopers & Lybrand.

Regulation of Derivatives

That having been said, I would like to talk briefly about my observations on the debates about possible regulation of derivatives. Clearly, this is a very broad topic, which in my view really relates to at least the three following facets:

1. Overall regulation of derivatives markets, both here in the U.S. and globally.
2. Possible regulation on the buy-side, that is, which types of investors and users should be involved with which types of derivatives. This is sometimes referred to as "suitability."
3. Possible regulation on the sell-side, that is, what standards, if any, ought to apply to those

who market these products to potential buyers -- what is often referred to on Wall Street as "sales practices."

Let me talk briefly about each of these aspects.

In regard to the overall market issues, the concern is that of so-called systemic risk, that is, that one of the major financial institutions that is a dealer in derivatives or a major user of derivatives might fail, which in turn might cause a chain reaction that could jeopardize the health of the whole financial system, a sort of "domino theory" of derivatives. This is a concern that was first raised in early 1992 by the then-president of the New York Federal Reserve Bank, Gerald Corrigan, and has since been argued from time to time by certain other parties, most notably the GAO in its report to Congress on derivatives last spring. The concern arises from the explosive growth of the derivatives market, recently estimated at over $35 trillion in notional value, most of which relates to the off-exchange or so-called over-the-counter products such as interest rate swaps, currency swaps, and foreign exchange contracts that are not subject to regulation in a way that exchange-traded futures and options, or, for that matter, stocks and bonds are. There have been congressional hearings on this topic and certain members of Congress have proposed that either the SEC or a new regulatory agency, a Federal Derivatives Commission, if you will, formally regulate this area.

While I again apologize that I am not the best qualified to comment on the merits of this concern, I believe that it is somewhat overblown. To my knowledge, there has been much focus and guidance coming out of such agencies as the OCC, the Fed, the FDIC, the NAIC, and others over the past two years in this arena. For example, the SEC and CFTC have instituted rules requiring securities and commodities trading firms to provide extensive detail on the derivatives activities of any affiliated entities that are not directly regulated by the SEC or CFTC, with a goal of preventing a spillover of losses by such affiliates to the regulated entities. Moreover, because of the global scope of this issue, international groups such as the Basle Committee on Banking Supervision, the Technical Committee of the International Organization of Securities Commissioners, and the Group of Thirty have also promulgated guidance in this arena. These efforts, which are aimed at dampening such risks, have included not only guidance on the risk management policies to be utilized by institutions that trade derivatives but also the appropriate oversight by boards of directors and senior management, as well as revised capital adequacy standards, proposed netting arrangements between institutions, and expanded and improved disclosures of derivatives positions. There is also a genuine concern, I believe, that overregulation of U.S. derivatives markets could drive significant segments of the market overseas.

While Congress is obviously mindful of all this, and even with a pro-business, anti-regulation Republican majority in Congress, it is always possible that, haunted by the specter of the S&L debacle and in the wake of other recent events, such as the reported losses on derivatives sustained by the government employees' credit unions, many members of Congress would rather err on the side of increased regulation lest the doomsayers prove correct. I am not one of the "Chicken Littles," and in that regard it is noteworthy that the derivatives and structured note markets seemed to have absorbed the Orange County event without any significant market dislocations. I therefore believe that the threat posed by derivatives lies less to the system as a whole than with the profitability and the financial viability of individual institutions and individual companies, investments funds, and other entities that are the users of, investors in, or traders of derivatives.

That, of course, brings me to the buy-side. I believe even a casual observer of the scene over the last year would have to conclude that some safeguards are needed. I'm sure that the stockholders of such companies as Procter & Gamble and Gibson Greetings, to name a few, as well as investors in mutual funds that suffered losses due to derivatives would agree. Certain products are not appropriate for certain users and there ought, in my view, to be clear speed limits in this regard. This applies particularly to such entities as money market and mutual funds, pension plans, college endowments, state and local government funds, and credit unions, who are trusted with the fiduciary duty of preserving capital. While he probably meant it to apply only to corporate end users, I would take issue with a former SEC Commissioner's statement in defense of managernent's prerogative to utilize derivatives as they deem appropriate when he stated, and I quote, "We must keep intact the inalienable right for individuals to lose money. If we ever lose the right, making money will become very hard indeed." Again, while this statement was probably aimed at corporate end users, I would certainly take issue with it in regard to the investment entities and funds where preserving invested capital is paramount. I am sure you will agree that if it's your money were talking about that is invested in a money market fund or a pension plan, management should not have an inalienable right to lose it on your behalf! Enough said.

It might well be asked how is it that all these so-called "surprise losses" occurred. Was it that the buyers just did not realize what they were buying, or was it that they did realize the potential riskiness of these investments but chose to roll the dice? I think there is some of both aspects. While it takes two to tango, it seems clear from public reports that in certain cases -- for example, Procter & Gamble and Gibson Greetings -- the buyers may have believed they were dancing a slow waltz rather than a tango. And that brings me to the sell-side.

Sales practice issues on Wall Street and across the country by other securities firms are, of course, not a new issue. However, because of the lack of specific regulation on derivatives as well as their complexity and virtually infinite variety, it certainly has provided a fertile area for product developers and marketers. By and large, however, I believe that most major Wall Street firms have approached this in a responsible manner. Indeed, many of them had instituted clear sales practice controls even before the latest wave of problems. I think that there is a growing appreciation that in the absence of such controls and codes of conduct, the institution runs the risk of not only greatly displeasing particular clients, but more importantly, it runs the risk of jeopardizing one of its most important assets, that is, its reputation. That notwithstanding, I continue even to this day to receive occasional calls from product developers and marketing people at certain firms who (I will assume without the endorsement of their employers) continue to seek loopholes in the accounting, tax, and disclosure rules. Maybe I am getting older; while I used to enjoy such conversations with these Rambo types, I now have little patience for them. By and large, however, these calls are becoming much less frequent. Clearly, it seems to me that most of the big Wall Street firms that had not already done so have now made concerted efforts to establish clear sales practices that will help potential buyers more clearly understand the risks and rewards of a particular product. In fact, I understand that, in something of an initiative at self-regulation, the big product dealers, under the auspices of the New York Fed, are developing a code of conduct in this area. All this bodes well because, of course, as we know from reading the newspapers, there have been some problems.

Again, going back to my analogy to dancing, I think one of my recent experiences helps to bring home some of the thinking and motivations on both the buy and sell sides, which underlie some of the fiascoes we have been reading about in the newspapers.

While somewhat similar to the Procter & Gamble case, this was not P&G, and, fortunately for the company involved in this particular case, the degree of leverage embedded in the interest rate swap it bought was nowhere near that in the P&G case. A few months ago, I got involved in a situation of a Fortune 100 company whose senior management, after reading about the P&G case and others, began to question the company treasurer about a certain interest rate swap the company had entered into. It turns out that the swap was indeed a leveraged swap, which, depending on the velocity of interest rate hikes during the particular reset period, could produce a leverage factor of 2.5 to 3 times. That is, if short-term interest rates rose by 100 basis points, the rate the company would pay would rise by 250 to 300 basis points. By the way, the P&G swaps reportedly had a leverage factor of around 10 times. As I got involved in this situation, it became clear to me that heretofore, while senior management and the board had been generally informed by the treasurer that the company had entered into a very sizable interest rate swap to change fixed-rate debt to floating, no mention of the leverage feature had been deemed worthy of communication up the line. Though I never got him to admit it, it was clear to me that the treasurer did not fully understand the product. In fact, in my view, and if I can use this word, he had been "seduced" by the investment banker who, back in August 1993, with interest rates at a modern low and with the chief economist of his own firm predicting that rates would go up over the next twelve to eighteen months, had convinced the treasurer that it was the perfect time to swap most of the company's debt obligations from fixed to floating and convinced him that the best way to do this was to enter into this particular swap. Although paying the company an above-market fixed rate, there was also what was described as a very minor catch, that being that if interest rates rose, the impact of such raises could be magnified. What the treasurer saw, I believe, was a way, at least in the short term, to reduce his company's borrowing costs because of the receipt of the above-market fixed rate, but did not comprehend or did not choose to comprehend the potential damaging impact that future rises in interest rates might have on this rosy picture. So here we have it on both sides -- a willing but perhaps not totally informed buyer and an eager salesman, both motivated by short-term objectives, that is, the treasurer wishing to show his board how he could minimize the company's borrowing costs, and the investment banker wishing to maximize his own personal cash flow.

Overall, however, I think that things are headed in the right direction, with the sellers of derivatives, in the wake of Bankers Trusts settlement with the SEC over Gibson Greetings, having been sent a clear message that they must take steps to ensure the risks and rewards inherent in an instrument (that is, the behavior of the instrument across a range of possible market scenarios is clearly highlighted) and with buyers increasingly realizing that they must fully understand an instrument and carefully consider the suitability of it for their needs before they buy it.

Management and Boards of Directors

Most of the studies and releases by regulatory agencies and by study groups such as the Group of Thirty and the GAO have pointed to the key importance of active involvement of management, boards of directors, and audit committees in the oversight and control of a company's derivatives activities. With that in mind, let me give you some of my views on this subject.

First, in terms of senior management involvement, while this of course varies from company to company, I believe that there is now a clear appreciation by most senior management, from the CEO down to the CFO and controller, of the need to get up to speed and involved in this area, and that in comparing this with the situation eighteen months ago, there has been real progress. In the past, for the end users, the subject of financial management, including the use of derivatives, was often left to the treasurer and his group without much monitoring by the CFO, the controller, internal auditor, etc. Often this whole area was viewed as not only complex but not related to the company's "real" business of manufacturing product, extracting oil, or selling airline seats. Also --and I will talk about this further in a few minutes -- the existing accounting rules, which quite honestly are rather piecemeal, often are internally inconsistent and do not cover many types of instruments and transactions, and often allow hedge accounting or some form of deferral accounting to be applied, thereby affording the treasurer the opportunity (often not malintentioned) to mask the eroding value of the derivative until the point that cash or additional collateral goes out the door. I think that this has been changing, and changing quickly, in the corporate community in the wake of Procter & Gamble, Gibson Greetings, et al., at mutual funds, and no doubt will now begin to change -- and one assumes at a fairly accelerated rate -- at state, county, and municipal organizations. I can tell you that having spoken at many such seminars and invited to speak at countless others, virtually every day in this fair city there is a well-attended derivatives seminar. Senior management, including CFOs, controllers, and internal and external auditors, are now eagerly attempting to get up to speed in this area and when they do, sometimes things do jump out of the woodwork. Let me give you an example. Following a seminar at which I spoke, I got a call from the controller of an oil and gas company who had attended the seminar and who, upon ordering a review of his company's derivatives activities, discovered that an internal derivatives trading group had been established in the past six months, ostensibly to better manage the oil price risk inherent in the company's business. In looking at the activities of this trading group, however, it became clear that they were doing more than merely hedging the commodity price risk in the business. In fact, the daily positions now amounted to five to six times the underlying daily production. Moreover, there was also active trading in and out of the positions. To date, these had been accounted for using a deferral approach, even though it seems the objectives were becoming more in line with earning trading profits and the traders were being compensated based on these trading profits. In fact, it seems the company, given this activity, seemed more like a commodities dealer than an oil and gas producer. My advice, with which the controller agreed and which he implemented, was to adopt a mark-to-market approach, not only because this better reflects the substance of the activity but, more importantly, because of the discipline that mark-to-market accounting imposes.

With regard to boards of directors and audit committees, the topic of derivatives has been on the agenda at most companies in the last year. I have attended a number of such meetings. In some cases, the discussion by board members has been substantive and probing. However, in many other cases, unfortunately, while the board or audit committee is quick to seek assurances from management and the external auditor that everything is okay, they are often very reluctant to get into any of the details or discuss in a substantive way any problems or concerns that may be raised. While I'm not advocating that board members get into all the nitty-gritty, this is not an area that is susceptible to glossing over. Maybe the reluctance to get into the details is due in part to the assumed and often actual complexity of the subject matter. However, I believe it often also reflects board members' concerns over potential exposure to unwanted liability; that is, on the advice of counsel, they have been told not to delve too far into this area. This, of course, runs counter to recommendations made by the many studies that have come out in the past year that have urged boards and audit committees to get more involved. The sad fact, I believe, is that often because of the fear of litigation and liability, the potential beneficial impact of boards and audit committees on this and, indeed, on other issues is often not being achieved.

On a related subject, I would also note that the Advisory Panel to the Public Oversight Board, headed by Don Kirk, in their report on "Strengthening the Professionalism of the Independent Auditor," also pointed to the need for more effective oversight of management by boards and audit committees. While I agree with most of what is in the Panel's report, I am concerned that much of the onus was focused on the auditor improving the level of interface with the board and expanding the extent and quality of the discussion with audit committees. While I would certainly agree that achieving greater board and audit committee involvement in the company's controls and financial reporting process and increasing and enhancing the level of discussion between the external auditor and the audit committee and the board are highly desirable objectives, I would question the attainability of these goals without serious changes in corporate governance in this country, a matter which the accounting profession can certainly encourage but over which we may have little control. As a closing note on this whole subject, I would also add that foreign companies looking to raise capital often cite as their two main deterrents for coming to the U.S. public markets the GAAP reconciliation that is required by the SEC in such filings and also, increasingly, the whole environment of litigation and its effect on corporate governance in this country. The new Republican majority in Congress, as part of the "Contract with America," has included litigation reform as one of their priorities. Needless to say, I wish them well.

So those are my views on some of the areas about which, again, I am not the most qualified to speak but on which, nonetheless, as a participant and observer of the scene, I have, as you can tell by now, some rather strong views.

Let me then turn, perhaps with a little less trepidation but nonetheless with a number of strong views, to those areas about which I feel I am better qualified to speak, that is, areas of accounting, disclosure, and auditing of derivatives activities. With respect to the accounting and disclosure issues, this has clearly been a long and winding road for the FASB and the SEC. The issues relating to derivatives are part of the FASB's broader financial instruments project, which is now nearing a decade since its inception. In fact, I can remember attending the first task force meeting some time after my 9-year-old daughter was born, and I suspect I may see this activity into her college years. You should all remember that when it comes to setting new accounting standards, you can't rush genius. The Board attempted to tiptoe into this area, first by improving disclosures relating to derivatives; thus it issued Statement 105, which focused on disclosure of information about financial instruments with off-balance-sheet credit risk, in

1990, and Statement 107, on disclosures on fair values of financial instruments, at the end of 1991. It soon became clear, however, for a variety of reasons, that the disclosures resulting from these two standards did not do a complete job in properly informing the reader of the extent of a company's use of derivatives; how that use related to its overall financial risk management; and how it affected the company's reported results, financial position, and overall risk profile. Thus, in early 1994, the Board, after several strong suggestions from the SEC and others, found it necessary to revisit the disclosure area in order to address the many concerns expressed.

All this coincided with increasing revelations by companies of surprise losses from derivatives, as well as an ever-loudening chorus of demands by Congress and various regulators for more transparent disclosures of derivatives by companies. I was one of those in that chorus. Clearly, many companies had taken a minimalist approach to disclosing information under Statements 105 and 107, the biggest problem, in my view, being that while disclosing the rather sterile quantitative information, they did not try to put these in the context of the company's over-all financial risk management policies, leaving the reader often baffled as to what the disclosures meant. I can remember, for example, a reporter calling me up regarding a certain computer company that, according to a major Wall Street analyst, was using derivatives to speculate on foreign currency on a large scale. The reporter sent me the analyst's report as well as the company's annual report and recent 10-Qs and asked me to read them to see if there were any violations of GAAP and any failure to disclose the extent of its use of foreign currency derivatives. I dutifully read all the material sent to me by the reporter, but, alas, I could not find any violations of GAAP or any failure to report anything that was required under Statements 105 and 107. However, it was difficult to tell from the footnotes and MD&A what the company was doing. Thus, I had to call back the reporter, tell him that, unfortunately, I could not find any direct violations of the rules, to which he asked if there was anything I could say on the subject. I told him that I guess that it would have been nice for the shareholders of the company and any prospective investors in the company to know that they are investing in a company that was more like a foreign currency dealer than a computer company since, based on the analyst's report, the company was speculating on foreign currency way beyond the natural needs of its business.

Does Statement 119 cure all this? The answer is probably not, but it does go a long way toward expanding and enhancing the disclosures. These now cover all freestanding derivatives, with the exception of commodity futures and other commodity-based derivatives contracts, which the FASB decided to exclude because they do not have to be cash-settled. Because of the extent of the required disclosures under Statement 119, I believe that most companies will feel it is necessary to relate the disclosures to their overall financial risk and risk management activities. Further, though not required, Statement 119 encourages additional disclosures, such as those related to how a company assesses and manages financial risk, i.e., an interest rate GAAP analysis for a bank and value-at-risk calculations for trading institutions. (In regard to value-at-risk, I would like to make some comments in a few minutes.) Moreover, the SEC has, through the review of filings for some 500 registrants, already required a number of companies to significantly expand and enhance their disclosures related to the financial risks faced by the company and how it manages those risks and how its use of derivatives relates to this risk management. It has also required disclosure of a company's specific accounting policies relating to different derivatives, as well as detailed disclosures on a company's derivatives activities during the year.

My fellow partner and former chairman of the SEC, Richard Breeden, has said that the best regulation of derivatives lies in improved market disciplines, which in turn depends on full and transparent disclosure of a company's derivatives activities to the market. I believe that we will see vastly improved disclosures in the current round of annual reports and agree that this is very healthy. Clearly, sunlight is the best disinfectant. It can also act on a company as a vaccine; that is, in order to make the disclosures, a company needs to both gather the information and to understand what it is doing. And, as I have previously noted, when a company does so, it sometimes finds things it may not have been fully aware of before.

Now, let me move on to the accounting. This has been a most vexing area because it not only highlights some of the core concerns with the historical cost model but also has surfaced some of the practical and conceptual problems that arise as we move from the historical cost model to a more market- or fair value-based accounting.

The Board has now been reconsidering the accounting for derivatives in earnest for some three years and has during that period changed direction a number of times. This has been a difficult project for the Board. The Board seemed headed for a possible speedier conclusion to this project back in June 1993 when it issued a document entitled "A Report on Deliberations Including Tentative Conclusions on Certain Issues Related to Accounting and Hedging and Other Risk-Adjusting Activities." While certain of the tentative conclusions in the Report on Deliberations contemplated potentially significant changes in the rules on accounting for derivatives and synthetics, the Board, at least at that point in time, continued to embrace the concepts of hedge accounting and synthetic instrument accounting. For example, while it was proposed that all freestanding derivatives be carried at market or fair value, hedge accounting would have been permitted for qualifying hedges of existing assets and liabilities and for firm commitments. Whether or not hedge accounting should be permitted for hedges of anticipated or forecasted transactions was left undecided, with several Board members sharing the concerns voiced by the chief accountant of the SEC over both the conceptual propriety of permitting deferral of gains and losses on such transactions and the practical concern over the ability to develop workable rules that would prevent companies from deferring losses in situations where the expected transactions might never materialize. The tentative conclusions also proposed a new method of hedge accounting, termed the "partial effectiveness method." Under this method, a hedge is considered effective to the extent that cumulative changes in the fair value of the hedging instrument do not exceed the (inverse) cumulative changes in the fair value of the item being hedged with any excess change in the fair value of the hedging instrument over the (inverse) change in the value of the hedged item being recognized currently in earnings. For financial institutions and other entities that manage net interest rate or currency risk of their over-all asset/liability position, the Report on Deliberations proposed an elective mark-to-market pool approach under which all components of a dynamically managed portfolio (i.e., assets, liabilities, commitments, and related derivatives) would be measured at market or fair value with the resulting gains and losses reported in current period earnings. Finally, with regard to synthetics, the Report on Deliberations described an approach under which a company would combine and initially measure the separate financial instruments used to create the synthetic as a single financial instrument measured at the net proceeds received or paid. In subsequent financial reporting periods, the company would recognize in current period earnings any difference between the combined fair values of the separate instruments and the fair value of the "prototype" instrument that the company was trying to synthetically create.

Since June 1993, when the Report on Deliberations was issued, the Board has continued its discussions on this topic. As evidenced by these discussions, the Report on Deliberations, though a noteworthy and interesting document, represented a very preliminary set of thoughts, and, as I mentioned before, the Board has since changed direction several times. While this may be due in part to the fact that two of the seven FASB members at the time of the Report on Deliberations retired and were replaced by new Board members, the heightened focus on derivatives in general and on the accounting for derivatives in particular by Congress, the GAO, the SEC, and others, together with the wave of reported losses and "busts" involving derivatives, has undoubtedly impacted on Board members' thinking. Critics of the current rules argue that not only are they incomplete and internally inconsistent, but moreover, any type of deferral accounting, whether it be in the guise of hedge accounting or synthetic instrument accounting, is harmful because it often masks the extent of a company's involvement with derivatives as well as the potential losses the company may suffer from using these instruments. An accounting method is needed, it is argued, that is not only less complex and that leaves less room for subjective judgments, but that also gives greater visibility to a company's use of derivatives by making sure they are captured on the balance sheet. Mark-to-market accounting, it is argued, will achieve all these objectives.

Thus it was that during 1994, while continuing to explore various hedge accounting methods, the Board also began to examine possible alternative mark-to-market approaches. As part of this effort, the Board considered a number of models that, while measuring all free-standing derivatives at market or fair value, also attempted to provide some sort of special or hedge accounting for a broad array of hedging and risk management techniques, including dynamic portfolio management, hedging forecasted transactions, and managing exposures to changes in cash flows and market values. In each case, however, Board members found that the methods proposed were either too complex and/or yielded results that were conceptually difficult to justify. Accordingly, in November 1994, the Board, in an effort to move the project ahead, instructed the FASB staff to develop a model under which a company would classify all freestanding derivatives into two categories -- "trading" and "other than trading." Derivatives classified as trading (which would include derivatives used to manage risk in a trading portfolio) would be measured at market or fair value with all gains and losses, realized and unrealized, recognized currently in earnings. Derivatives classified as other than trading would also be measured at market or fair value. However, the unrealized gains and losses would be included in a separate component of stockholders' equity until realized, at which point the realized gain or loss would be transferred from stock-holders' equity and recognized in earnings. Since November 1994, the Board has been continuing down the path of developing this approach, having also tentatively decided that commodity futures and other commodity-based derivatives that entitle the holder to settle in cash or via receipt or delivery of the commodity, as well as certain other instruments that have derivative-like characteristics, such as interest-only strips and some structured notes, should also be encompassed by this proposed accounting approach. The Board has also tentatively decided that with regard to regulated futures, the daily settlement for changes in value via variation margin should be treated as an event of realization requiring immediate recognition of the value change in earnings.

The proposed approach, which is similar to the one adopted by the Board for debt and marketable equity securities in Statement No. 115, would effectively eliminate hedge accounting and synthetic instrument accounting as they are now known. Proponents of this approach argue that it has a number of advantages, including the following:

> It captures on the balance sheet the fair value of all derivatives used by a company. As a result, it may provide the reader with in "early warning" of any major adverse changes in such fair values. Thus, it over-comes the weakness of current hedge accounting practices that have sometimes masked major potential adverse changes by keeping them off-balance-sheet.
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> Accounting will not depend on the type of instrument used or the type of risk hedged. The proposed approach is broad and consistent for a wide range of instruments and a wide range of hedging, risk management, and risk selection strategies.
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> The approach and the resulting accounting procedures are simple and easy to understand. As a result, it should be much less costly to implement than the current rules.
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> If the maturities of the hedged items and the hedging instruments are matched, the proposed approach still provides for appropriate offsetting of gains and losses in the income statement. The wide array of available over-the-counter and customized derivatives should permit entities to choose those instruments that will enable them to accomplish this objective.
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> Entities would have the flexibility to decide when derivative-related gains or losses would be reported in the income statement because the timing of realizing those gains or losses would be within their control.

On the other hand, opponents of the proposed approach believe that the proposal's focus on the balance sheet treatment of derivatives will result in an inappropriate portrayal of hedging activities in the income statement. In effect, the traditional hedge accounting and "matching" concepts have been ignored by this proposal. For example:

> Entities would not be able to fix the U.S. dollar cost of commitments to purchase fixed assets from foreign suppliers. The gains or losses on the forward-exchange contracts entered for this purpose would be included initially in stockholders' equity and transferred to earnings when the contract matures or is sold prior to maturity. They cannot be part of the basis of the fixed asset purchased.
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> Derivatives that hedge inventory or any other assets or liabilities that are carried at cost would cause changes in equity but the offsetting gains or losses on the hedged items would not be reflected on the balance sheet.
>
> The use of derivatives to permanently hedge translation adjustments reported in equity (e.g., on hedges of a net investment in a foreign subsidiary) would be effectively eliminated.
>
> The proposed approach would eliminate synthetic instrument accounting, even for "plain vanilla" interest rate swaps that synthetically change fixed-rate debt into floating and vice versa.
>
> It would increase volatility of stockholders' equity. Under the current accounting model, certain assets and most liabilities are carried on an historical cost basis. However, the derivatives that were acquired to hedge these items will be measured at fair value, with unrealized gains and losses, immediately impacting stockholders' equity. Thus, even if the change in the value of the derivative perfectly offsets the change in value in the hedged item, stockholders' equity will only reflect the change in the value of the former. As a result, the proposed approach treats stockholders' equity as a "dumpster" by adding unrealized derivative-related gains and losses to the list of other items recorded in equity under current GAAP, e.g., foreign currency translation adjustments and unrealized gains and losses on available-for-sale securities. The Board has severely clouded what constitutes "income" and has not adequately explained why the expanded stockholders' equity section would now be better for the financial statement users. Whatever happened to the "clean" surplus theory?
>
> In an effort to properly match the timing of recognition in earnings of gains and losses on derivatives with the related gains or losses on the items being hedged, companies may, of necessity, increasingly have to turn to over-the-counter instruments that may be more risky than exchange-traded futures and options. This would seem particularly true in the case of futures, where the daily settlement would be treated as a realized gain or loss.

Clearly, entities in different industries would be affected differently by this proposal. Companies sensitive to fluctuations in capital, such as banks and other regulated entities, would probably oppose the proposal. On the other hand, many commercial entities may welcome the freedom and flexibility offered by the proposal to hedge any type of risk with any type of derivative. This is particularly relevant in the area of hedging forecasted transactions because current hedge accounting rules require that if a hedging instrument does not meet specified criteria, it should be marked-to-market with the changes recorded in the income statement.

Whichever the case, companies will certainly need to carefully reassess and appropriately modify their hedging and risk management approaches should this proposed approach be enacted by the Board.

What do I think about the Board's current direction? I must confess I am somewhat schizophrenic on this proposal. The practitioner in me, tired of the daily debates related to the current rules and the lack of clarity and subjectivity, says to himself, at least this approach is simple, uniform, and objective. On the other hand, the theoretical accountant in me, perhaps too used to the "matching" concept and the notion that a meaningful portrayal of earnings is the keystone of financial reporting, is troubled by this proposal. While it would now capture all derivatives on the balance sheet, it would do so, in my view, at a high cost. In further expanding the use of stockholders' equity as a dumping ground, it, in my view, further dilutes the meaning of earnings and net income. All this is at a time when, according to the Jenkins Committee and the AIMR study "Financial Reporting in the 1990s and Beyond," the analysts are looking for a return to the clean surplus approach with an ability to capture and distinguish within net income the results of all activities.

Overall, it seems to me that the approach that the Board seemed headed toward in its June 1993 Report on Deliberations was more promising. That is an approach that would recognize that one size does not fit all in terms of accounting for derivatives. For financial institutions and other entities that manage portfolios of both on- and off-financial instruments, it seems to me that the right answer in the end is mark-to-market or fair value for all financial instruments, including derivatives. However, when you get to hedging of other exposures that are not yet recorded on the balance sheet or are related to assets or liabilities that are not carried at fair value, then a more traditional hedge accounting model should be permitted. However, its use should be circumscribed to those situations where the intent and effect is clear and virtually certain.

Before leaving the subject of accounting and disclosure, I think it is important to realize that while added detailed disclosures and a better and more comprehensive set of accounting rules are clearly necessary and desirable, they are not the only and maybe even not the best way of conveying information on a company's use of derivatives and on its over-all financial risk profile. In that regard, we should remember that over the past five to seven years there has sprung up the discipline of financial risk management, involving highly quantitative techniques that are designed to quantify in a standardized way the extent of market risk inherent in a particular portfolio of financial instruments and related derivatives, and, indeed, the financial risk across all the portfolios in an institution. Out of this has come a concept of value-at-risk, which is a measure of the potential loss resulting from hypothetical changes in market factors such as interest rates and foreign exchange rates for a given time period. For example, a particular institution might define its value-at-risk as the potential daily loss across all the financial instruments in its portfolio that would result from adverse market movements within, say, a 95 percent confidence level. By providing this sort of benchmark, the company is not only providing a measure of the riskiness of its portfolio but is also indirectly conveying information about the extent to which it hedges or speculates. Now, a number of major financial institutions are already providing this type of disclosure, and its use is being increasingly endorsed by the SEC and other regulators. In this regard, I think an analogy can be made between the development of this kind of quantitative discipline and its possible use as a benchmark disclosure with the development many years ago of actuarial techniques and their subsequent use in pension accounting and disclosures.

Let me move briefly now to some of the auditing issues relating to derivatives and how these have, for example, impacted our practice. We, of course, audit a wide spectrum of entities across all industry sectors. Ten years ago it was largely only the securities firms where we had to worry to any great extent about auditing derivatives. This is no longer the case. And thus, we have had to meet this challenge by training our people, by developing new tools, including, for example, derivatives controls questionnaires, and by developing or purchasing our own valuation models. It has also opened up major new service areas for us, such as financial risk management consulting and internal control-related services. For example, starting about three to four years ago, we decided to create a global financial risk management practice consisting of professional financial risk managers, and we now have core groups in New York, London, and Tokyo that can go into a company or institution, map and quantify its financial risks, and advise on risk management strategies' and related systems, procedures, and controls. Often, in more complex situations, we use these individuals as part of our audit evaluation of a particular company. I noted that we have created or purchased a variety of derivatives valuation models and have trained many of our staff on these. In certain circumstances, however, a client -- most notably a derivatives product dealer -- may have certain very complex or long-dated instruments in its portfolio (for example, a 40-year Swedish krona swap containing a series of embedded caps and floors). In such circumstances, we have turned to outside specialists to help us assess the reasonableness of the client's valuation procedures, methodologies, and end results. A number of these outside specialists come from academia, such names as Hull and White, and Gifford Fong, to name a few.

Finally, I would like to leave you with a few thoughts and perhaps suggestions regarding how all this may impact on your activities. First, of course, there are curriculum issues. Just as we have had to train our people to understand derivatives, how companies use them, and what the audit, accounting, and disclosure implications are, I believe that this subject matter needs, as appropriate, to be built into your accounting and auditing courses. In today's world, I believe this would be a serious omission. Enough said. Secondly, with regard to academic research, this whole area provides very fertile ground. With all the fuss in the past year, with new disclosures and with likely changes in the accounting rules, there would seem to be a whole host of opportunities for academic research on, for example, how each of these things has impacted stock prices overall, particular industries, particular companies, and how new regulations, new disclosures, and new accounting rules impact companies' approaches to risk management. I hope that my comments here tonight may have stimulated your thoughts on other areas for research.

In closing, I would just say that derivatives are clearly here to stay and that it is important that we all understand that, if used properly, they can be extremely valuable financial tools, but that, as events of the past year have shown, if not properly understood or controlled, they can be extremely dangerous to a particular entity. I am optimistic that recent events, while certainly sobering, are already beginning to have a very salutary effect on the various participants in the market. That is good, because I would not mind a respite from the battlefield duty.

QUESTIONS AND ANSWERS

Question:
Sometimes these transactions really aren't as bad as they seem. It's a general image that companies that engage in derivative transactions are doing something terrible, and it may not really be terrible. Assume someone wanted to buy a house and needed to have a mortgage for $100,000 and would have preferred a fixed rate of 9 percent. And assume he was able to get a variable rate, and then actually entered into an interest rate swap, and at the end of the day converted that transaction into a fixed rate of 8-1/2 percent. So if he just went to a bank and borrowed $100, 000 and paid 9 but because he is high-techish had managed to end up paying 8-1/2, that would be deemed to be smart and prudent and not particularly unusual -- he accomplished something good. But on the other hand, if someone said that my neighbor is entering into derivatives and interest rate swaps, it would sound fantastically complicated and risky.

Answer:
That's a very good observation: put it all in balance. Recently, somebody tabulated the reported losses. I think the number for publicly reported losses may have added up to approximately 15 billion dollars. We are talking about a market that some have estimated at 35 trillion. So we are talking about the losses being a very small segment. Most companies are using these in a healthy way, the way they are meant to be used, without getting too exotic or beyond the natural exposures of the company. But there is that temptation out there to increase yield by using things like debt to reduce borrowing costs and be the instant hero. These are some of the things I talked about. Thank you.